NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON THE PROPOSED FATCA REGULATIONS

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New York State Bar Association Tax Section

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This report (the "**Report**")[1] comments on the proposed regulations under Sections 1471 through 1474 of the Code (commonly referred to as "**FATCA**") issued on February 8, 2012 (the "**Proposed Regulations**") and the joint statement regarding FATCA implementation between the governments of the United States, France, Germany, Italy, Spain and the United Kingdom (the "**Joint Statement**") that was released simultaneously with the Proposed Regulations.[2] The Proposed Regulations provide extensive guidance relating to the implementation of the FATCA reporting and withholding regimes and in many places take into account comments provided by financial institutions, practitioners and others to the U.S. Department of the Treasury ("**Treasury**") and the Internal Revenue Service (the "**IRS**") with respect to the FATCA regime in general and preliminary guidance issued by Treasury and the IRS in a series of Notices.[3]

Each Part of this Report provides background and recommendations about particular areas of relevance under the Joint Statement and the Proposed Regulations. Part I discusses the proposed intergovernmental approach to implementing FATCA that is described in the Joint Statement. Part II discusses the definition of foreign financial institutions ("**FFIs**") under the Proposed Regulations. Part III discusses the Proposed Regulations' rules for when FFIs will be deemed to be compliant under FATCA without having to become participating FFIs ("**PFFIs**"). Part IV discusses the requirements for being a PFFI under the Proposed Regulations and the agreements that FFIs have to enter into to be PFFIs. Part V discusses the rules relevant to non-financial foreign entities ("**NFFEs**"). Part VI discusses issues related to which payments are subject to withholding under the Proposed Regulations. Part VII discusses the mechanics of

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[2] References in the 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. FATCA was enacted as part of the Hiring Incentives to Restore Employment Act of 2010, Public Law 111-147 (the "**HIRE Act**"), which added these sections as chapter 4 of Subtitle A of the Code ("**chapter 4**").

[3] Notice 2010-60, I.R.B. 2010-37; Notice 2011-34 , I.R.B. 2011-19; and Notice 2011-53, I.R.B. 2011-32.

withholding under the Proposed Regulations. Part VIII discusses transition and grandfathering rules.[4]

Summary of Recommendations

We commend Treasury and the IRS for their considerable effort in the Proposed Regulations and the Joint Statement to balance FATCA's basic policy goal of using expanded information reporting to curb tax evasion by U.S. persons against the need for a regime that is clear and administrable by a widely divergent range of foreign entities, as well as by U.S. financial institutions and other U.S. withholding agents. The Proposed Regulations provide highly detailed rules on a range of issues that had only been addressed in part (or not at all) in previous guidance, and they do so in a manner that we believe is genuinely responsive to many of the legitimate concerns expressed by affected financial institutions and other stakeholders.

We provide in the body of this Report a series of specific recommendations on how the Proposed Regulations could be refined to enhance their administrability without compromising the basic goals of FATCA. We also provide comments on how intergovernmental agreements of the type envisioned in the Joint Statement could be drafted in a manner that complements and adds to the efficacy of the statute and its supporting regulations.

Each of the eight Parts of the Report contains a separate summary of the recommendations related to that Part's subject matter. In view of the large number and broad range of issues addressed in the Proposed Regulations and the Joint Statement, we have not listed all of our recommendations in this opening section of the Report. We nevertheless highlight below some of the key issues that we have addressed.

1. We believe the Joint Statement's intergovernmental approach to the implementation of FATCA has the potential over time to substantially enhance the smooth operation of the chapter 4 regime and to eliminate, or at least alleviate, potential conflicts between that regime and the laws to which FFIs are subject in their home countries. Intergovernmental FATCA implementation agreements can and, we believe, should be used to tailor the rules of chapter 4 to the specific features of the financial sector in each partner country. For example, the Proposed Regulations identify categories of FFIs that predominantly serve investors residing in the FFIs' home country and that are deemed to be compliant with FATCA (without undertaking the diligence, reporting and withholding responsibilities of a PFFI) based on the FFIs' financial characteristics and the local legal or regulatory regimes to which they are subject; under an implementation agreement, these categories can be adapted to the particular features of the legal, regulatory and commercial environment in a partner country. By

[4] For ease of reference, the Appendix at the end of this Report ties each of our recommendations to the specific requests for comments in the preamble to the Proposed Regulations (the "**Preamble**"), and then lists (in the order set forth in the Proposed Regulations) each provision in the Proposed Regulations affected by our recommendations.

comparison, we suggest that multinational financial institutions with substantial subsidiaries or branches in many different countries that may otherwise be subject to the separate requirements of many different FATCA implementation agreements with the United States should be subject to requirements that are either the same or substantially identical in each implementation agreement. We believe this will reduce some of the current uncertainty regarding the nature and scope of these agreements and the related reporting obligations for multinational institutions. We discuss these and related points in Part I.

2. The Proposed Regulations properly recognize that the broad definition of an FFI (which potentially includes all vehicles that derive a majority of their income from stock, debt or other enumerated financial assets) has the potential to reach large number of foreign entities that Congress did not intend to target, including holding companies of operating subsidiaries and treasury or finance subsidiaries within corporate groups engaged in active businesses other than banking, custodial or insurance businesses. The Proposed Regulations seek to narrow the considerable breadth of the definition by excepting many categories of entities and institutions from FFI status. However, we believe that several of the categories of excepted FFIs created in the Proposed Regulations will not apply to many of the foreign entities they are meant to reach. In Part II of the Report, we suggest that most categories of excepted FFIs be replaced with rules that test an "expanded affiliated group" on an aggregate basis to determine whether the group is principally engaged in the active conduct of a trade or business (other than a financial services business). If the group is so engaged, then all members of the group should be excepted FFIs and excepted NFFEs, other than group members directly engaged in a banking, custodial, insurance, or other similar financial services business. We discuss this point and related recommendations in Part II.

3. We support the Proposed Regulations' adoption of categories of deemed-compliant FFIs that will be exempt from the more burdensome requirements of FATCA. However, we believe that the special regime for "owner-documented" FFIs should be modified in a manner that makes it easier for family-owned vehicles to qualify for such regime. Specifically, owner-documented FFIs should be allowed (i) to borrow, (ii) to have any type of payor (and not just a U.S. financial institution or PFFI) serve as an authorized withholding agent, (iii) to have another owner-documented FFI as an owner and (iv) generally to be subject to less expansive documentation requirements than the Proposed Regulations contemplate. In addition, we believe that the requirements associated with several of the other categories of deemed-compliant FFIs should be simplified, and some of those categories of deemed-compliant FFIs should be combined. With these changes, we believe that such FFIs and their withholding agents will have much less difficulty determining their deemed-compliant status under chapter 4, and FATCA's policy goals will not be sacrificed. We discuss these points in Part III.

4. The Proposed Regulations reflect a comprehensive attempt to impose manageable requirements on PFFIs. Nevertheless, we believe the Proposed Regulations leave unresolved at least two significant questions for an FFI that is considering whether to seek PFFI status. First,

although withholding on foreign passthru payments will be a major task for many PFFIs, no guidance is provided in the Proposed Regulations on the scope of this obligation because the Proposed Regulations do not define the term. Pending future guidance, we propose that the IRS issue interim guidance limiting withholding on foreign passthru payments to payments on financial accounts; we believe this will provide a useful start to many financial institutions in assessing the scope of their future obligations with respect to these payments. Second, we believe the "all or nothing" rule should be relaxed to permit an expanded affiliated group to continue to hold indefinitely (rather than just through the end of 2015) a historically owned FFI that is prohibited under laws in effect prior to the enactment of FATCA from complying with the PFFI requirements and from closing its existing U.S. accounts, provided that the group adopts safeguards designed to prevent such FFI from opening new U.S. accounts. We discuss these two points, as well as a number of other comments to the PFFI rules, in Part IV.

5. The rules for NFFEs will have limited scope under FATCA, given the broad definition of FFI adopted in the Proposed Regulations. To impose a manageable burden on NFFEs, the rules governing the identification of substantial U.S. owners by these entities should be clarified and simplified, in particular by providing that, if an NFFE does not have actual knowledge that any specified U.S. person owns over 10% of the NFFE through intermediate foreign entities, then the NFFE will have a reasonably limited duty to gather information about its indirect owners.

6. Although it is helpful that the rules dealing with the mechanics for withholding under FATCA are modeled on the corresponding rules under chapter 3, we believe that even closer conformity to these rules will help to streamline the withholding process for payments of U.S. source FDAP. We also believe the rules for withholding on gross proceeds should be revised in a number of respects, including by (i) clarifying that withholding does not apply to gross proceeds from a disposition of stock or debt of a foreign issuer, (ii) allowing a PFFI a choice between being withheld upon under Section 1471(b)(3) or itself withholding on gross proceeds it receives, and (iii) clarifying that a nonparticipating FFI or NFFE entitled to the benefits of a tax treaty is generally entitled to a refund of withholding on gross proceeds. Parts VI and VII of the Report discuss these and related issues.

7. As discussed in Part VIII, the Proposed Regulations would benefit from clarified and broadened grandfathering rules – including rules extending the grandfathering period for obligations that give rise to foreign passthru payments and that provide for grandfathering of equity of vehicles that principally hold grandfathered debt.

Discussion

I. Intergovernmental Approach to Implementing FATCA

A. Background

The governments of the United States, France, Germany, Italy, Spain and the United Kingdom released the Joint Statement simultaneous with the issuance of the Proposed Regulations.[5] In that statement, they agreed to explore an intergovernmental approach to the implementation of FATCA by the United States, under which the United States would enter into agreements with the other five countries that would provide for the United States and each partner country to collect and exchange, on a reciprocal automatic basis, information about accounts of the partner country's financial institutions held by U.S. persons as well as U.S. accounts held by the partner's residents.

The Joint Statement indicates that a FATCA implementation agreement between the United States and a partner country would provide for all FFIs in the partner country to be excused from the requirement under Section 1471 to enter into an FFI agreement with the IRS in order to be exempt from withholding under Section 1471.[6] In lieu of signing an FFI agreement, the partner country's FFIs (possibly excluding certain FFIs identified in the FATCA implementation agreement between the United States and the partner country or in IRS guidance) would be required to perform diligence on accounts held by U.S. persons and to provide information to the partner country's government, to be forwarded to the United States automatically. The partner country's FFIs would be exempted from chapter 4 withholding tax on payments made to them. They also would be exempted from any requirement to withhold U.S. tax on passthru payments to recalcitrant account holders, or to FFIs established in other countries that had entered into FATCA implementation agreements with the United States.[7] Finally, FFIs in the partner country would be exempt from any requirement under FATCA to close accounts. The United States would commit to collect and report automatically to the partner country's authorities information about U.S. accounts of the partner country's residents.

The Joint Statement notes that FATCA "has raised a number of issues, including that FFIs established in these countries may not be able to comply with the reporting, withholding

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5 In addition, on April 24, 2012, Ireland has announced that it has entered into discussions with the U.S. Department of the Treasury regarding a bilateral agreement for implementing FATCA. David D. Stewart, *Ireland Joins Discussions on FATCA Agreement*, 2012 TNT 80-4 (Mar. 25, 2012).

6 *See* Joint Statement, Paragraph B.2.a.

7 The Joint Statement contemplates an exemption from foreign passthru payment withholding on payments made by an FFI in a partner country to FFIs in other partner countries; and the Proposed Regulations contemplate that a FATCA implementation agreement may exempt an FFI from withholding on passthru payments to recalcitrant account holders. *See* Prop. Reg. § 1.1471-4(b)(1).

and account closure requirements because of legal restrictions." [8] Under a FATCA implementation agreement, the partner country would commit to seek necessary legislation to enable FFIs in the partner country to comply with the obligation to report the information required under FATCA and the agreement.

In addition, the Joint Statement provides that the United States and the five partner governments would commit "to develop a practical and effective alternative approach to achieve the policy objectives of passthru payment withholding that minimizes burden."[9] Treasury's and the IRS's openness to this approach is also stated in the Preamble.[10]

B. Summary of Recommendations

1. Each FATCA implementation agreement with a partner country should be negotiated in a manner that is tailored to any unique or distinguishing characteristics of participants in that country's financial services industry that have operations mainly or exclusively in that country. For multinational institutions with material operations in many partner countries, however, the implementation agreements should standardize the reporting obligations.

2. Consideration should be given to modifying the regime for withholding on foreign passthru payments, once the United States has entered into a network of FATCA implementation agreements.

3. When Treasury begins to negotiate a FATCA implementation agreement with a partner country, Treasury may wish to consider offering to treat those FFIs in the partner country that are prohibited under local law from becoming PFFIs as deemed-compliant until such time as the country concludes good faith negotiations and the relevant legal prohibitions are lifted.

C. Discussion

We applaud Treasury for its efforts in working with the other participating countries to issue the Joint Statement. We believe that if Treasury broadens the basic approach reflected in the Joint Statement and negotiates a network of FATCA implementation agreements with those countries and a range of others as well, then such agreements could be used to ensure a more precisely tailored and equitable means of imposing reporting and diligence obligations on FFIs.

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8 Joint Statement, Paragraph A.2.

9 Joint Statement, Paragraph B.4.a.

10 *See* Preamble, 77 Fed. Reg. 9022, 9023, 9026-28 (Feb. 15, 2012).

1. ***Each FATCA implementation agreement with a partner country should be negotiated in a manner that is tailored to any unique or distinguishing characteristics of participants in that country's financial services industry that have operations mainly or exclusively in that country. For multinational institutions with material operations in many partner countries, however, the implementation agreements should standardize the reporting obligations.***

Each FATCA implementation agreement should be negotiated in a manner that takes into account particular characteristics of the partner country's financial services industry, in order to agree on categories of FFIs organized or operating in that country that are treated as deemed-compliant FFIs or are subjected to reduced withholding, due diligence and reporting requirements in order to become PFFIs.[11] This is particularly important for FFIs that do business primarily or exclusively in the partner country. For example, the Proposed Regulations provide that "local FFIs" and "nonregistering local banks" that meet certain requirements are deemed-compliant FFIs; in a FATCA implementation agreement, some of those requirements could be modified so that they tie in with specific local laws governing FFIs (e.g., local licensing requirements) and also so that they fit well with the commercial reality of how the financial sector is structured in the partner country. Similarly, the detailed rules in the Proposed Regulations that give deemed-compliant FFI status to pension funds and other retirement vehicles also could be modified to fit logically with a particular partner country's tax and regulatory requirements for such vehicles. Furthermore, depending on the number and size of the participants in the country's financial sector, it might be appropriate to agree on different tiers of requirements for FFIs of different sizes or that engage in different functions (e.g., a small regional or local institution that focuses on a limited range of financial services, versus a larger full-service bank).

Once the United States enters into a critical mass of FATCA implementation agreements, an approach in which each FATCA implementation agreement imposes different obligations on FFIs organized or having operations in the relevant country could prove highly burdensome to multinational institutions with material subsidiaries or branches in several countries, as compared to smaller organizations with operations largely confined to a single partner country. For example, some multinational institutions might be required to implement different procedures for compiling and submitting different packages of data regarding their account holders in different countries under each FATCA implementation agreement. It would be appropriate to consider how best to mitigate these potential burdens for international financial institutions. One

[11] The Joint Statement refers to a FATCA implementation agreement as applying with respect to FFIs "established" in the relevant partner country. We believe it would be appropriate to treat an FFI as "established" in a partner country if it either is organized under the laws of that country or has a branch in that country. A local branch could generally be treated in the same manner as a local subsidiary in an implementation agreement.

approach would be for every FATCA implementation agreement to separate such financial institutions into standardized categories or tiers; uniform obligations would then be imposed on the financial institutions within each such category or tier, under the FATCA implementation agreements with every partner country where the institution has a branch or subsidiary. It should be possible to establish uniform categories or tiers for large international financial institutions in each implementation agreement without imposing standardized categories or tiers on the smaller or more locally focused FFIs in each partner country. Each agreement would instead be tailored to deal specifically with such smaller or more local participants in the financial industry in a particular partner country, as described above.[12]

2. Consideration should be given to modifying the regime for withholding on foreign passthru payments, once the United States has entered into a network of FATCA implementation agreements.

An additional benefit of intergovernmental agreements is that they would provide an opportunity to resolve many of the jurisdictional issues related to foreign passthru payments. We have previously noted the jurisdictional and policy issues concerning the legal right of United States to impose withholding on payments of foreign-source income by one FFI to another.[13] In this regard, it appears that the jurisdictional claim of the United States may be strengthened if an intergovernmental agreement with a partner country expressly acknowledges that FFIs located in the partner country must withhold under Section 1471 on payments to nonparticipating FFIs.

In addition, once the United States has entered into several intergovernmental agreements, we suggest that consideration be given to altering the basic framework of the foreign passthru payment regime. One possibility would be to provide in these agreements that the partner country would impose withholding under its own laws on specific classes of payments by resident FFIs to any account holders that fail to provide information to the FFI, or to FFIs in countries that have not entered into comprehensive automatic information exchange agreements with the partner country (comparable to a FATCA implementation agreement). In exchange, the United States would exempt FFIs in the partner country from any obligation to withhold U.S. tax on foreign passthru payments. The objective of this approach is to collectively encourage other jurisdictions to accept the basic principle of comprehensive, automatic tax information exchange

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[12] Ultimately, the system of bilateral FATCA implementation agreements might even be replaced with a multilateral agreement among the United States and its partner countries. A multilateral agreement might be drafted relatively easily to set forth uniform obligations for the members of a multinational financial group to provide standardized information to the tax authorities in each participating country concerning the residents of that country, while at the same time imposing more tailored obligations for an FFI with a presence confined largely or solely to a given country to provide a limited amount of information about its account holders to the tax authorities of the participating countries.

[13] *See* New York State Bar Association Tax Section, *Report on IRS Notice 2011-34 and IRS Notice 2011-53* (Rep. No. 1253, Jan. 12, 2012).

by imposing monetary penalties on FFIs in jurisdictions that decide not to negotiate information exchange agreements of this kind with the United States and its partner countries.

We acknowledge that the approach described above, or any other approach to modifying the passthru payment rules by intergovernmental agreements, will present practical challenges, particularly in the case of global financial institutions with branches and affiliates in many other countries. Nevertheless, an alternative system based on the principle that the partner country (rather than the United States) would impose tax on payments by FFIs located in the partner country should enhance the general administrability of the regime, and would be consistent with the basic policy preference for implementing the FATCA regime by intergovernmental agreement.

3. When Treasury begins to negotiate a FATCA implementation agreement with a partner country, Treasury may wish to consider offering to treat those FFIs in the partner country that are prohibited under local law from becoming PFFIs as deemed-compliant until such time as the country concludes good faith negotiations and the relevant legal prohibitions are lifted.

Foreign governments will have substantial incentives to enter into FATCA agreements with the United States. First, such agreements are likely to alleviate what would otherwise be significant compliance burdens under FATCA for many FFIs in a partner country. Second, such agreements would entitle foreign governments to data generated by U.S. financial institutions to detect and prosecute tax evasion by their own citizens and residents. Such data will extend well beyond the information that partner countries now receive from the United States and its residents on a routine or automatic basis under current treaties and information exchange agreements.[14] As an additional incentive to strengthen a partner country's commitment to negotiating and observing the terms of an implementation agreement, Treasury in appropriate cases may wish to consider offering temporary relief from full compliance with FATCA to any FFI in the partner country that is prohibited under local law from complying with the provisions of chapter 4.

For example, if a partner country agrees during negotiations that it will pursue the relevant changes in local law promptly after execution of an implementation agreement, then Treasury may wish to consider granting temporary but immediate deemed-compliant status to FFIs that (1) are organized in or have a branch in that country and (2) are prohibited under local law from complying with one or more requirements imposed on PFFIs until a short period beyond the date of the agreement to allow sufficient time for such changes to become effective.

[14] We note that entry into intergovernmental agreements would also lessen the incentive for foreign governments to enact their own statutory counterparts to FATCA, which would potentially subject U.S. financial institutions to disparate and possibly inconsistent requirements for diligence, reporting and withholding.

In such a case, the affected FFIs would not be subject to FATCA withholding pending execution of the FATCA implementation agreement.

We anticipate that such relief might be offered principally or exclusively when the relevant legal prohibition was in effect prior to enactment of FATCA, since prohibitions of this kind are likely to serve national policy goals of the partner country that are not related in any way to the FATCA regime. We also anticipate that a temporary accommodation of the type described above might be granted by the United States with a fixed and publicly announced end date, in order to discourage potential partner countries from attempting to achieve de facto permanent deemed-compliant status for their resident FFIs by protracted negotiations not carried out in good faith. Treasury might also reserve for itself the discretion to extend the fixed date in appropriate cases.

If Treasury were to decide in a particular case to grant deemed-compliant status to FFIs in a partner country pending the execution of an implementation agreement and changes in local law, Treasury and the IRS should also consider whether they should publicly announce the specific types of FFIs in the partner country eligible for such relief (assuming that the relevant legal prohibition does not apply to every FFI in that country). Such an announcement should minimize any confusion regarding whether a particular FFI is entitled to deemed-compliant FFI status during this period. Treasury and the IRS also could tailor deemed-compliant status so that, if an FFI is permitted under local law to satisfy some but not all of the requirements imposed on a PFFI, the FFI would be subject to those requirements not inconsistent with local law.

If Treasury and the IRS determine that having the flexibility to grant temporary deemed-compliant status to FFIs in a partner country is likely to facilitate the successful negotiation of some FATCA implementation agreement, then the Proposed Regulations could be modified to make reference to Treasury's authority to do so in its sole discretion.[15]

We note the Proposed Regulations provide that an FFI that is a member of an expanded affiliated group of PFFIs can be a deemed-compliant FFI without entering into an FFI agreement if that FFI (1) conducts due diligence in the same manner as a PFFI on its existing accounts, (2) closes or transfers to an affiliate (which is itself a PFFI or U.S. financial institution) any existing accounts that are identified as U.S. accounts or accounts of nonparticipating FFIs and (3) establishes procedures to identify any new accounts identified as U.S. accounts or accounts of nonparticipating FFIs and transfer them to an affiliate within 90 days after opening them.[16] We believe this rule does not diminish the value of offering the type of temporary deemed-compliant status discussed above during the period of negotiation. First, the rule in the Proposed

[15] Although the Proposed Regulations state that an executed FATCA implementation agreement may provide for categories of deemed-compliant FFIs, they do not state that Treasury may identify temporary categories of deemed-compliant FFIs during the negotiation of these agreements. *See* Prop. Reg. § 1.1471-5(f)(1).

[16] Prop. Reg. § 1.1471-5(f)(1)(i)(B).

Regulations would provide no relief during the duration of negotiations of a FATCA implementation agreement for an FFI organized in the partner country, unless the FFI is a member of a group that also includes a PFFI or U.S. financial institution. Because the Proposed Regulations also require FFIs to differentiate between account holders based on national origin and require FFIs to close or transfer accounts without the consent of the customer, they may conflict with restrictions under the privacy, antidiscrimination and universal banking laws of some countries account holders. Further, even if local law does not prohibit the diligence and account closure or transfer requirements mandated by Proposed Regulations section 1.1471-5(f)(1)(i)(B), we nevertheless believe the time and expense required for many FFIs to comply with these requirements will be significant. In view of this, the prospect of a discretionary offer by the United States of temporary deemed-compliant status to FFIs in a partner country pending a change in local law is likely to be perceived as an incentive by many partner countries to negotiate an implementation agreement.

II. Scope of Definition of FFI

A. Background

Under Section 1471(d)(4) and Proposed Regulations section 1.1471-5(d), an FFI is defined as a financial institution that is not organized in the United States or a U.S. possession. A "financial institution", in turn, generally includes any entity that: (1) accepts deposits in the ordinary course of a banking or similar business; (2) holds financial assets on behalf of others as a substantial (at least 20%) portion of its business; (3) is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities and other similar assets; or (4) is an insurance company and is obligated to make payments on certain insurance contracts with an investment element or other financial accounts.[17]

The Proposed Regulations provide that certain entities ("**excepted FFIs**") are excluded from the definition of an FFI because they are primarily engaged in nonfinancial activities.[18] Excepted FFIs include: (1) foreign entities substantially all of the activities of which consist of owning subsidiaries that conduct nonfinancial trades or businesses, or "nonfinancial holding companies"; (2) foreign entities not yet operating a business but intending to start a nonfinancial business, or "start-up companies"; (3) foreign nonfinancial entities that either are liquidating or are emerging from a reorganization or bankruptcy and intend to continue nonfinancial operations; (4) companies that serve as hedging or financing centers for nonfinancial corporate

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17 Prop. Reg. § 1.1471-5(e)(1).

18 The Proposed Regulations refer to such entities as "excepted FFIs". *See* Proposed Regulations section 1.1471-1(b)(18). Such entities are also "excepted NFFEs" that are not subject to withholding under Section 1472. *See* Proposed Regulations section 1.1472-1(c)(1)(v).

groups; and (5) charitable organizations.[19] An excepted FFI has no obligation to identify and report on U.S. holders of accounts issued or maintained by it, withhold on foreign passthru payments, or meet any of the other requirements that are generally imposed on FFIs as a condition to receiving payments free and clear of withholding.

B. Summary of Recommendations

1. Final regulations should clarify when a foreign entity "is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting or trading in" stock or securities of the kind enumerated in Section 1471(d)(5)(C) and the Proposed Regulations.

2. Several of the categories of excepted FFIs should be replaced with a broader, clearer rule that generally excepts from the definition of FFI all members of an expanded affiliated group that, on a combined group basis, is principally engaged in the active conduct of a nonfinancial trade or business. This exception, however, would not apply to any member of such a group that is a depositary bank, custodian, insurance company, securities dealer or other entity engaged in a similar financial services business.

3. Final regulations should clarify that if an investment fund holds a controlling interest in a holding company that in turn owns entities that actively conduct a trade or business, the holding company/ies for the fund's investment in such operating companies would be excepted FFIs, even though the fund itself would be an FFI.

4. If recommendation 2 is not accepted, then several of the proposed categories of excepted FFIs (those for a nonfinancial holding company, a company emerging from reorganization or bankruptcy, and a hedging or finance center) should be clarified.

C. Discussion

1. Final regulations should clarify when a foreign entity "is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting or trading in" stock or securities of the kind enumerated in Section 1471(d)(5)(C) and the Proposed Regulations.

Section 1471(d)(5)(C) provides that a foreign entity is an FFI if it "is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting or trading in" stock, debt and other specified types of financial assets (an "**Investment FFI**"). We propose that the regulations clarify the meaning of being engaged in "the business of investing." On the one hand, these words could be read as simply describing an entity that derives the majority of its gross income from dividends, interest, gains and other amounts realized with respect to stock, debt and the other types of assets specified in the definition. On the other hand, the statute refers

[19] Prop. Reg. § 1.1471-5(e)(5).

to "the business" of investing, which could be read as requiring more. For example, the reference to a "business" of investing might be read to mean that an entity will be an Investment FFI only if it is marketed or held out to customers as providing a place to invest their liquid assets. An entity marketed or held out in this manner could be viewed as performing as a financial intermediary similar to the role of a depositary or custodial institution and therefore subject to the same obligations. This might be seen as the dividing line between those foreign investing entities that are subject to the relatively high burdens placed on FFIs pursuant to Section 1471, and those foreign entities that are NFFEs subject to the supporting regime in Section 1472.[20]

Proposed Regulations section 1.1471-5(e)(4), which defines "engaged primarily in the business of investing, reinvesting and trading", leaves some uncertainty regarding this point. At present, this Proposed Regulation merely states that an entity fits within the phrase just quoted if its income from "such activities" exceeds 50% of its total gross income over a 3-year testing period, without defining "such activities".

On balance, it may be more consistent with Congressional intent to adopt a broad definition under which any foreign entity that receives the majority of its income from holding securities and the other types of enumerated financial assets is considered to be an FFI, regardless of whether, for example, the entity has customers or is marketed as an investment fund or similar vehicle. The apparent purpose of the statute is to prevent U.S. taxpayers from using a foreign entity to make investments in passive assets while evading their reporting and payment obligations under the Code with respect to those investments. That purpose appears to be best served by this broader definition.

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[20] Notice 2010-60 states that the Investment FFI category "generally includes, but is not limited to, mutual funds (or their foreign equivalent), funds of funds (and other similar investments), exchange-traded funds, hedge funds, private equity and venture capital funds, other managed funds, commodity pools, and other investment vehicles." The Notice then goes on to state:

> The concept of “business” as used in section 1471(d)(5)(C) is different in scope and content from the concept of a "trade or business" as used in other sections of the Code. For example, isolated transactions that might not give rise to a trade or business for other purposes may cause an entity to be engaged primarily in the business of investing, reinvesting, or trading in securities, depending on such factors as the magnitude and importance of the transaction in comparison to the entity's other activities.
>
> Treasury and the IRS anticipate that regulations will provide that whether an entity is engaged primarily in the business of investing, reinvesting, or trading in securities must be determined on the basis of all relevant facts and circumstances. Although the analysis is ultimately fact-specific, Treasury and the IRS contemplate that future guidance will provide guidelines for determining what types of activity, carried on in whole or in part, constitutes the business of investing, reinvesting, or trading, and when an entity is primarily engaged in such a business.

We note that, while we believe the basic definition of an Investment FFI should be broad, we also believe it is appropriate to recognize that it will sweep in a far broader group of investment entities, including many family-owned and similar investment entities not formed to evade U.S. tax that lack the necessary systems or resources to comply with the PFFI regime. As discussed further in Part III of this Report, we believe that the "owner documented" FFI rules in the Proposed Regulations provide a more appropriate and practical way for investment vehicles of this kind to avoid the more burdensome obligations of FATCA so long as they are modified in the manner described in Part III.C.8 below.

In addition, we note a technical issue related to Proposed Regulations section 1.1471-5(e)(4). The final year in the 3-year testing period referenced in the Proposed Regulation appears to be the current year, i.e., the year in which the entity must make a determination as to whether it is an FFI and (in the event it is) take appropriate action to qualify as a PFFI. As such, some entities may not know whether they have satisfied the income test until the third year has ended and their gross income for that entire year is known. To address this concern, final regulations could provide that the relevant 3-year testing period is the period ending at the close of the year *before* the year in which the entity must determine whether it is an FFI.[21]

2. Several of the categories of excepted FFIs should be replaced with a broader, clearer rule that generally excepts from the definition of FFI all members of an expanded affiliated group that, on a combined group basis, is principally engaged in the active conduct of a nonfinancial trade or business. This exception, however, would not apply to any member of such a group that is a depositary bank, custodian, insurance company, securities dealer or other entity engaged in a similar financial services business.

The Proposed Regulations seek to grant relief from FATCA to companies that conduct an active business other than the business of a depositary bank, custodian or insurance company, as well as holding companies for companies that conduct such businesses. However, the proposed rules leave a number of gaps and inconsistencies, which we believe are best addressed by adopting in place of the proposed rules a regime that examines the activities of a group as a whole.

In particular, the definition of "nonfinancial holding company" raises a number of interpretive issues.[22] First, it uses, but does not define, the term "subsidiary," leaving open the

[21] For an entity that has been in existence for only one or two years prior to the current year, the test could be based on the results for those one or two years; and for a newly formed entity, there could be a presumption that it is not an Investment FFI so long as it intends to conduct an active business as its principal activity.

[22] A nonfinancial holding company is defined as "a foreign entity substantially all of the activities of which is to own (in whole or in part) the outstanding stock of one or more subsidiaries that engage in trades or businesses,

questions of what threshold of equity ownership (by vote and/or value) is required for subsidiary status. The definition also does not address the question of whether an indirectly held company is a subsidiary:

> **<u>Example 1</u>**. A, B and C are all foreign corporations. A owns as its sole asset 100% of the stock of B, which in turn owns as its sole asset 100% of the stock of C. C conducts a trade or business and is not a financial institution. C periodically pays dividends to B, which in turn periodically pays dividends to A.

Depending on how the interpretive issue addressed in our recommendation 1 above is resolved, it appears that in Example 1, both A and B may qualify as Investment FFIs as defined in Section 1471(d)(5)(C) and Proposed Regulations section 1.1471-5(e)(1)(iii). It also appears that B qualifies as a nonfinancial holding company. However, since B does not itself directly conduct a trade or business, it is not clear whether A qualifies as a nonfinancial holding company (i.e., whether substantially all of A's assets consist of stock of a subsidiary that engages in a trade or business).

If the facts are changed so that B is directly engaged in a trade or business, that might also lead to an unfavorable outcome:

> **<u>Example 2</u>**. The facts are the same as in Example 1, except that in addition to owning the stock of C, B also actively conducts a nonfinancial trade or business (i.e., a trade or business of a type that would not cause B to be treated as an FFI) worth 400. B's stock in C is worth 600, and C owns nothing other than a nonfinancial trade or business that C conducts. C distributes all of the profits of its trade or business to B each year as a dividend.

On these facts, B may be an FFI, assuming that at least 50% of B's gross income over a 3-year period consists of the dividends that it receives from C and that merely receiving large amounts of dividends over such period is sufficient to qualify as an Investment FFI.[23] B will not qualify as a nonfinancial holding company, because it is not the case that substantially all of its assets consist of stock of subsidiaries that are engaged in trades or businesses (assuming that 60% does not constitute "substantially all"). As a result, A also will not qualify as a nonfinancial holding company. It seems difficult to justify these results as a policy matter because, in the aggregate, A, B and C have no assets other than the nonfinancial trades or businesses conducted by B and C. In addition, a modest change in form significantly changes the outcome in Example 2: if C elects to be treated as a disregarded entity (or if B liquidates C and holds C's business

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provided no such subsidiary is a financial institution." The definition specifically excludes any private equity, venture capital, leveraged buyout or similar investment fund. Prop. Reg. § 1.1471-5(e)(5)(i).

[23] *See* Prop. Reg. §§ 1.1471-5(e)(1)(iii) and (e)(4).

directly), then it appears that B will not be an FFI, and A will qualify as a nonfinancial holding company. It is not clear that it is intended, or appropriate, that the parties' form should make such a significant difference.[24]

In addition, the concept of a nonfinancial holding company seems not to fit smoothly with other categories of excepted FFIs.

> **Example 3**. D, E and F are all foreign corporations. D's sole assets are the stock of E and F, with each corporation's stock being worth 500. E actively conducts a nonfinancial trade or business and owns no assets other than those used in that business. F is a startup company (or, alternatively, is emerging from bankruptcy or is undergoing a liquidation), as described in Proposed Regulations sections 1.1471-5(e)(5)(ii) or (iii). E and F both pay dividends to D.

Both E and F escape treatment as FFIs, in this example. However, it appears that D is an FFI, subject to the interpretive issue discussed in recommendation 1 above. D does not qualify as a nonfinancial holding company, because it is not the case that substantially all of D's assets are stock of subsidiaries engaged in trades or businesses. There is no obvious rationale for this result.

Issues similar to those just described for the "nonfinancial holding company" exception also appear to arise in the NFFE regime, in the definition of an active NFFE. A corporation is an active NFFE if more than 50% of its gross income for the preceding year is other than "passive income" (e.g., dividends and interest) and more than 50% of its assets for that year do not produce and are not held for production of "passive income".[25]

> **Example 4**. G and H are both foreign corporations. G actively conducts a nonfinancial business and also owns 100% of the stock of H, which also actively conducts a nonfinancial trade or business. Over 50% of G's total gross

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[24] More broadly, the requirement that none of a nonfinancial holding company's subsidiaries can be a financial institution appears overly restrictive. Corporate groups engaged in an active nonfinancial business will often include at least one member that meets the definition of a financial institution (e.g., a dormant company that has no assets other than a small amount of investments, such as a loan it has made to an affiliate under a cash pooling arrangement).

[25] *See* Prop. Reg. § 1.1472-1(c)(1)(v). In this connection, we note that the Proposed Regulations state that an entity is an active NFFE if either more than 50% of its gross income for the preceding year is not passive income, or more than 50% of its assets in the past year did not produce and were not held for the production of passive income. The Preamble, however, states that in order to be an active NFFE, an entity must meet both the income and the asset tests. We understand that in fact, the IRS's intent is accurately reflected by the Preamble, and the IRS plans to correct the final regulations to replace "or" with "and". Kristen A. Parillo & Marie Sapirie, *IRS to Issue FATCA Clarifications Soon*, 2012 TNT 46-2 (Mar. 8, 2012).

> income for the 3-year period from 2012 through 2014 consists of income from the trade or business that G conducted. However, when 2014 is reviewed separately, 50% or more of G's income for that year consists of dividends received from H.

In Example 4, G is not "engaged primarily in the business of investing" within the meaning of Proposed Regulations section 1.1471-5(e)(4) and thus is not an Investment FFI. However, under Proposed Regulations section 1.1472-1(c)(1)(v), G does still qualify in 2015 as an NFFE that is not an active NFFE, because no more than 50% of G's gross income for that year was generated by the trade or business directly conducted by G. By comparison, G would qualify as an active NFFE if H elected to be treated as a disregarded entity or was liquidated by G. Again, there is no clear policy justification for such results.

In addition, it appears the exception for active NFFEs does not fit easily with the basic principles underlying some of the categories of excepted FFIs.

> **Example 5**. I, a foreign corporation, actively conducts a nonfinancial trade or business. I forms J, a new foreign corporation, as a subsidiary, and contributes cash to J which J invests temporarily in short-term investments, pending use of the cash to start up a new business.

In Example 5, I will not be an FFI, assuming it does not receive material dividend income from J (or material amounts of other passive income). In addition, J will be a start-up company that is an excepted FFI.[26] By comparison, if J elects disregarded entity status, then all of its investment income will be attributed to I; and if such investment income is large enough in amount, it might cause I to become an Investment FFI (depending on the resolution of the interpretive issue described in section 1). The result will be the same, if I establishes a branch to begin a new business, rather than forming a subsidiary to begin that business.

We believe that the apparent purposes behind creating the categories of excepted FFIs and NFFEs described above could be better served, and the importance of legal form and legal separation among the members of a corporate group that constitute an economic unit could be appropriately diminished, if the rules described above are modified along the following lines. The premise of the proposed modifications is (1) generally to treat the entities in a corporate group as excepted FFIs and excepted NFFEs if the group's main activity is to conduct active nonfinancial businesses (i.e., active businesses other than being a depositary bank, custodian or insurance company), but (2) to treat the entities in a corporate group as (depending on the circumstances) either non-excepted FFIs or NFFEs if the group's main activity is to hold investment assets or to engage in financial businesses. This basic premise would be implemented through a series of related rules.

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26 *See* Prop. Reg. § 1.1471-5(e)(5)(ii).

First, all members of an expanded affiliated group of entities would be tested on an aggregate basis, to determine whether the group as a whole is an "active" nonfinancial group.[27] For this purpose, an active nonfinancial group could be defined as one less than 50% of whose gross income is "passive income" or financial services income and less than 50% of whose assets produce or are held for the production of passive income or financial services income. The definition of "passive income" would be based on the definition in Proposed Regulations section 1.1472-1(c)(1)(v)(A)-(J) (i.e., dividends; interest; rent and royalties, to the extent not derived from the active conduct of a trade or business; annuities; death benefits; amounts received from or with respect to a pool of insurance contracts that depend on the performance of the pool; gains from assets giving rise to the types of income just described; commodities gains; foreign currency gains, and income from notional principal contracts). Financial services income would consist of categories of income commonly earned by depositary banks, custodians and insurance companies (fees for extending or agreeing to extend credit, brokerage fees, insurance premiums, etc.).[28]

Second, when applying the income test just described, a group member's dividends, interest, rent or royalties or other income received from other group members would be disregarded. In addition, when applying the asset test, a group member's holdings of shares, debt, leases, licenses and other contracts with other group members would similarly be disregarded.

Third, we suggest that passive income and assets in limited cases would count as active, for purposes of the 50% tests just described. If a group member is a start-up company as defined in Proposed Regulations section 1.1471-5(e)(5)(ii), for example, then its income and assets would count as active for purposes of testing the group. The same would be true for the assets and income of a start-up business that is held in branch or disregarded entity form, rather than as a separate entity that is regarded for U.S. tax purposes. A similar approach would be taken for a company or branch that historically conducted a nonfinancial business and is in the process of liquidation or is the subject of an insolvency proceeding.[29] Finally, a logical extension of the principle that passive assets are sometimes held as a natural outgrowth of a bona fide business,

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27 We have chosen the expanded affiliated group as the unit to be tested because, in another context within the same statutory scheme, Congress chose to view that group effectively as an integrated unit (*see* I.R.C. § 1471(e)(2) (generally requiring that an FFI can qualify as a PFFI only if all other FFIs in the group also opt to be PFFIs)), and we believe that for simplicity and consistency it will be helpful to use the same basic standard for what constitutes a group.

28 *Cf.* Treas. Reg. § 1.904-4(e)(2) (listing types of income considered to be derived in the active conduct of a banking, insurance, financing or similar business); Prop. Reg. §§ 1.1296-4(f), 1.1296-6(e) (providing that income from listed activities is considered to be income from banking activities or securities broker-dealer activities).

29 *See* Prop. Reg. § 1.1471-5(e)(5)(iii).

would be to treat at least a limited amount of a group's assets as working capital for its conduct of a trade or business.[30]

Fourth, although an entity in which group members own 50% or less is not itself a member of an expanded affiliated group, in certain circumstances it might be appropriate to take an aggregate or look-through approach to shareholdings in such entities and income received from such entities. For example, in analogous contexts, look-through or aggregate treatment in effect has been granted where members of a corporate group own a 33% interest in a partnership, or own a 20% interest and play a significant role in management of the partnership.[31] In other contexts, aggregate or look-through treatment has been granted in the case of a 20% or 25% shareholding in a corporation.[32]

Fifth, we would suggest that the rules for measuring income and assets under the 50% test be designed with a view toward ease of administrability, to the extent this can be achieved without sacrificing other relevant policy goals. In particular, we believe that a group should be given a choice among two or more of the following metrics for purposes of measuring its assets: (i) fair market value; (ii) tax basis as computed under U.S. principles; and (iii) book value as determined on audited annual financial statements. In a similar vein, a group (or at least a group no member of which is required to file a U.S. tax return or to regularly provide information to U.S. shareholders for purposes of the shareholders' income tax reporting) should be entitled to choose to measure gross income using either U.S. tax principles or the same accounting principles that are applied for purposes of preparing the audited financial statements of the group or its members.[33] In addition, a group should be entitled to choose between the calendar year and its members' fiscal year for financial statement purposes. These proposals are designed to serve the basic purpose of exempting only those groups of companies that, in the aggregate, conduct a bona fide active business unrelated to being a financial institution, while at the same time recognizing that many foreign corporate groups (and standalone companies) may face a significant burden if they cannot rely on pre-existing local financial statements in order to determine whether they are excepted FFIs.

Sixth, we propose that a group's income and assets be analyzed over a testing period that is longer than one year – say, three years – in an effort to avoid penalizing companies that

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[30] *Cf.* Treas. Reg. § 1.897-1(f)(3)(i) (creating a safe harbor for treatment of a portion of a corporation's assets as working capital, when testing whether the corporation is a U.S. real property holding corporation).

[31] *See* Treas. Reg. § 1.368-1(d)(4)(iii)(B) and Prop. Reg. § 1.355-3(b)(2)(v)(B).

[32] *See* I.R.C. §§ 355(g)(3)(B)(iv) and 1297(c).

[33] This approach would be consistent with the rules under Treasury Regulation section 1.1471-4(d)(4)(iv)(E), which provides flexibility to a PFFI regarding the measurement and reporting of income paid to account holders.

experience temporary dips in income from active nonfinancial business operations and/or in the amount of assets held to produce such income.

Seventh, in the event that an expanded affiliated group qualifies as an active nonfinancial group under the standards described above, we propose that each foreign entity that is a member of the group be treated as an excepted FFI and an excepted NFFE, subject to limited exceptions. Specifically, there would be an exception for any member of the group that is an FFI under Proposed Regulations sections 1.1471-5(e)(1)(i), (ii) or (iv) (i.e., a depositary bank, a custodian or an insurance company). Similarly, it may be appropriate to exclude other members as well to the extent such members, while not within any of these categories, are nevertheless engaged in a financial services business. For example, a group member that is a securities dealer that completes transactions with more than a minimum number of third-party customers per year or that engages in a lending business and makes more than a minimum number of loans to third-party borrowers per year might be excluded from such relief.[34] In addition, in the case of a corporate group operating an active trade or business that is owned by an investment fund, the active group might exclude any fund vehicle or any person owning an interest in a fund vehicle. We discuss further below in our recommendation 3 the considerations relevant to defining an investment fund and distinguishing it from the portfolio companies owned by the fund.

This proposed framework would appear to lead to rational results in cases like Examples 1 through 5 above. A holding company that directly or indirectly owns solely (or primarily) operating subsidiaries that conduct nonfinancial businesses would be an excepted FFI and an excepted NFFE, regardless of whether the operating subsidiaries are disregarded entities. In addition, groups that combine operating companies with start-ups or liquidating or insolvent affiliates would also be able to qualify for exceptions to status as FFIs or NFFEs.

Furthermore, a group member that has income and assets that are predominantly passive, but that is integrated into an active nonfinancial group, would also be an excepted FFI and excepted NFFE under the above proposals. For example, a group finance or treasury company would qualify; and as a result, the separate category of excepted FFI involving a financing center of a nonfinancial group[35] would no longer be necessary. Similarly, if a group has an intellectual

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[34] In the case of an active nonfinancial group, we believe it is reasonable to treat certain members as FFIs even though they are not depositary banks, custodians or insurance companies. Without such a rule, an active nonfinancial group could rely on its status as such to conduct a financial services business not subject to FATCA regulation on the basis that the business is not the principal business of the group. On the other hand, we believe that clear, objective standards for identifying which members of an active nonfinancial group are engaged in a disqualifying financial services business are critical. Without such standards, the primary objective of our recommendation -- to minimize uncertainty regarding which group members (e.g., holding companies, group treasury or finance companies, etc.) are eligible for excepted status -- may well be compromised. *Cf*. Prop. Reg. §§ 1.1296-4(b)(2), (e), 1.1296-6(b)(3), (e) (setting standards for the securities activity required of an active dealer and the lending activity required of an active bank).

[35] Prop. Reg. § 1.1471-5(e)(5)(iv).

property holding company that has income consisting mainly of royalties paid by affiliates that are actively engaged in a nonfinancial trade or business, that company also would qualify as an excepted FFI and excepted NFFE under these proposed rules. The proposed approach also would generally deal appropriately with cases in which different functions that together amount to the conduct of an active trade or business are split among different members of a group (for example, a group in which employees are employed by a single employee leasing company, which seconds the employees to affiliates that hold operating assets).[36]

By comparison, under the proposed framework, if an expanded affiliated group failed the income and asset tests described above, then all members of the group generally would be either FFIs or passive NFFEs. The group members would be FFIs, if 50% or more of the group's combined assets were stock or securities (or other enumerated financial assets) or were held for use in conducting financial services businesses (the businesses of being a depositary bank, custodian, insurance company, securities dealer, or other similar financial services provider), or if 50% or more of combined income was income from stock and securities (and other financial assets) and/or income from financial businesses. The group members would be passive NFFEs, if the group did not satisfy the FFI test described in the preceding sentence, but 50% or more of the group's combined gross income was passive income; however, in such a case, each entity that directly engaged in the business of being a depositary bank, custodian, insurance company, securities dealer, or other similar financial services provider would still be treated as an FFI. We recommend these rules because, in the case of a corporate group that is an economic unit and that predominantly conducts a financial business or otherwise has predominantly passive-type assets and income, it generally seems fair to evaluate the status of the group's members by considering the character of the group in the aggregate, rather than by looking separately at each member. This approach should also reduce opportunities for creating arbitrarily different outcomes by separating certain activities, assets or income streams into different legal entities and keeping others within a single entity.[37]

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36 *Cf.* Prop. Reg. §§ 1.355-3(b)(1)(ii) and -3(d)(2) Example (5).

37 In the case of groups that are not treated as active nonfinancial groups under this framework, consideration could be given to permitting such groups to treat particular group members as excepted FFI or NFFEs if the activities of such members consist entirely or predominantly of directly conducting an active nonfinancial business. Arguably, a rule that would permit a particular group member to be treated in this manner could be viewed as inconsistent with our general recommendation that FFI and NFFE status should be tested on a group basis. If a group's members would generally qualify as FFIs or NFFEs only if the group as a whole is not an active nonfinancial group, then it could be argued that the reverse should also be true: the group's members should qualify as not being FFIs or NFFEs only if the group as a whole is an active nonfinancial group. On balance, however, we believe that permitting a group member that conducts an active nonfinancial business to be an excepted FFI and excepted NFFE is consistent with our general recommendation.

Our recommendations are intended primarily to provide a framework for dealing with group members that do not conduct any business and, instead, principally hold passive assets. Under our proposals, such group members

We note that under the approach described above, it may be appropriate to allow a group that initially qualifies as an active nonfinancial group, but later ceases to qualify, some additional time to implement the systems and reporting mechanisms necessary to comply with FATCA.[38] For example, if an active nonfinancial group ceases to qualify, then some of its members may become FFIs for the first time. Treasury and the IRS should consider deferring the deadline for such group members to enter into an FFI agreement covering the first year in which they are FFIs. Similarly, the deadlines for such group members to report the information required with respect to their account holders under the PFFI rules might be extended for the first year or two in which such group members are FFIs. These members also might be permitted to report on only limited categories of financial accounts under the PFFI rules.

A significant benefit of the group approach outlined above is that it appears such an approach would reduce the possibility for sudden shifts for an entity between its status for

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would be tested for FFI or NFFE status by reference to the overall activities of the group. By contrast, a member of a group that actively conducts a financial services business (a depositary bank, custodian, insurance company, dealer, etc.) would always be treated as an FFI under our proposed approach, even if it is part of an active nonfinancial group. Consistent with this approach, a complementary rule would be to always treat a group member whose sole or predominant activity is conducting a nonfinancial business as an excepted FFI and excepted NFFE. In this connection, we note that an entity whose sole or predominant activity is the conduct of an active nonfinancial business is normally an unlikely source of useful information to the IRS even if the entity were to comply with the rules applicable to PFFIs or passive NFFEs. Such an entity generally would have no "financial accounts" to report other than perhaps its own debt or equity obligations. Moreover, the equity of such an entity is likely to be held by other members of the group (who would themselves have the independent obligation under FATCA to gather information about the holders of their own equity). The fact that full-blown FATCA reporting by such companies would tend to yield little useful information to the IRS regarding U.S. tax evasion tends to establish that they should qualify for excepted status.

If Treasury and the IRS do decide to grant excepted FFI status and excepted NFFE status to a group member that actively conducts a nonfinancial business even though the group as a whole fails the test for qualifying as an active nonfinancial group, then Treasury or the IRS should consider imposing certain limitations on this approach in order to limit the potential for abuse. For example, rules could be adopted requiring that substantially all of the income of the member results from its direct conduct of a nonfinancial business and substantially all of its assets produce or are held for the production of such income. In addition, rules might be adopted to limit the amount of outstanding debt of the member to an amount not in excess of the funds necessary to conduct its business. Among other things, limitations of this kind would help to ensure that groups comprised of some FFI members and some active nonfinancial members could not choose to receive and/or make foreign passthru payments through the group's active nonfinancial members (rather than the FFI members), in order to avoid passthru payment withholding.

Whether or not Treasury and the IRS adopt this approach, however, we recommend that FFI and NFFE status should generally be tested on a group basis.

[38] For example, an active nonfinancial group might fail to meet the necessary requirements it if sells active nonfinancial businesses or buys financial businesses or investment assets. A group could also cease to be an active nonfinancial group if its active nonfinancial businesses no longer represent over 50% of the group's total income and assets due to a decline in economic performance.

purposes of Sections 1471 through 1474 as an FFI, an NFFE, or an entity that is excepted from both FFI and NFFE status. Given the extent of the burdens imposed on an FFI, an entity that (if tested on a standalone basis) might realistically attain FFI status without an applicable exception would likely begin to plan for, and incur some of the expense associated with, compliance with the FFI regime even if it was not yet actually an FFI – for example, a start-up company that expected it might still have a significant amount of liquid assets on hand more than 24 months after its formation, or a company in an insolvency proceeding that it expected could realistically last more than 5 years. If an active nonfinancial group test is introduced in place of entity-by-entity testing, that could provide more predictability in cases where the composition of the assets and income of the group, viewed as a whole, does not change substantially over time.

3. Final regulations should clarify that if an investment fund holds a controlling interest in a holding company that in turn owns entities that actively conduct a trade or business, the holding company/ies for the fund's investment in such operating companies would be excepted FFIs, even though the fund itself would be an FFI.

If the basic approach described in recommendation 2 is accepted, then the status of investment funds under FATCA arguably becomes open to question. Under one view, there is not a great deal of difference between a privately owned holding company that owns various operating subsidiaries conducting one or more different active trades or businesses – under the above approach, such a holding company would not be an FFI or an NFFE – and a typical private equity or venture capital fund (or a hedge fund that takes some controlling positions in the shares of operating companies). Essentially, the fund is merely another holding vehicle above the operating companies in the structure. On that basis one might conclude that the fund itself should be treated as a part of an active group and therefore exempted from status as an FFI and, possibly, status as an NFFE as well. However, it appears that Congress contemplated that such funds would be FFIs, and we believe that result is consistent with the purposes of the statute.[39]

If final regulations take the approach that an investment fund will be an FFI, even if its assets consist predominantly of controlling stakes in operating companies that conduct active businesses, then it will be important for the regulations to provide an appropriate definition of an investment fund. The Proposed Regulations refer to a foreign entity that "functions (or holds itself out) as an investment fund, such as a private equity fund, venture capital fund, leveraged buyout fund or any investment vehicle whose purpose is to acquire or fund companies and then hold interests in those companies as capital assets for investment purposes."[40] This standard

39 *See* J. COMM. ON TAX. REP. 4-10, at 44 (2010) ("[T]he term financial institution may include among other entities, investment vehicles such as hedge funds and private equity funds.").

40 Prop. Reg. § 1.1471-5(e)(5)(i).

appears to focus mainly on the type of assets the entity owns – shares of companies that are held as capital assets. We believe that a clearer and more easily administrable definition would focus on an entity investing in stock and other financial assets that is marketed to investors as a private equity, venture capital, hedge, mutual or similar investment fund and that has an investment manager or investment adviser that receives fees or other compensation for services (e.g., a "carried interest"). This definition would presumably be broad enough the cover each member in a family of affiliated fund vehicles (e.g., a master vehicle and different feeders).[41] In our view, this approach would appropriately impose the same burdens on investment funds as on other categories of financial intermediaries that perform comparable functions for investors, by treating such funds as FFIs.

We do not believe, however, that FFI treatment should also extend to holding companies owned by such a fund that own the shares of specific portfolio operating companies.

> **Example 6**. Foreign Fund, a foreign entity that is a private equity fund, owns Foreign Holdco, a foreign corporation. Foreign Holdco has borrowed from third parties, and it owns as its sole assets 100% of the shares of Foreign Opco (a foreign corporation) and U.S. Opco (a U.S. corporation), as well as intercompany notes of Foreign Opco and U.S. Opco. Each Opco conducts an active nonfinancial business of selling products and services to third party customers; Foreign Opco's customers are located outside the United States, and U.S. Opco's customers are located within the United States.

Structures like the one in Example 6 are widely used, for a range of commercial reasons that are wholly unrelated to FATCA and its policy objectives.[42] The choice of jurisdiction for the holding company (the United States, Foreign Opco's home country, or some other jurisdiction) is

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[41] If the fund documents permit specific limited partners in the fund to co-invest in portfolio companies alongside the fund (for example, in order to avoid paying the full carried interest or management fees payable by other limited partners in the fund), and the fund forms a special vehicle for these co-investors to do so, we believe the vehicle should be treated as a non-exempt FFI. Essentially, such a vehicle is a component part of the fund, formed solely to facilitate the same investment under different economic terms by specific fund investors. If such a vehicle were not treated as an FFI, it might be possible to avoid information reporting under FATCA with respect to such investors. The same reasoning would apply if the fund documents allowed the management team of the fund to co-invest in portfolio companies alongside the main fund, perhaps through a similar co-investment vehicle.

Although vehicles of this kind may reasonably be viewed as merely an extension of the fund itself (and thus a non-exempt FFI), we do not believe this approach should be applied more broadly to holding company vehicles for separate portfolio company investments by the fund. We discuss our reasoning for this conclusion immediately below, in the text of the report relating to Example 6.

[42] For example, the purpose of having a holding company above a multinational group of operating subsidiaries may be to provide centralized management, to facilitate the tax-efficient movement of cash within the group or to accommodate the demands of lenders for a single borrower with access to the income and assets of the entire group.

generally driven by the jurisdictions in which operating subsidiaries do business and the attractiveness of the governance and income tax rules of the holding company jurisdiction. Similar considerations also motivate non-fund shareholders to acquire operating businesses through foreign holding company structures. Indeed, Foreign Holdco in Example 6 may well have been formed by the historic shareholders that owned the Opcos prior to a sale to Foreign Fund.

Further, treating Foreign Holdco in Example 6 as an FFI would not appear to advance the policy objectives of FATCA. The basic goal of the statute is to promote the gathering and reporting of information about account holders of FFIs. Assuming that Foreign Fund in Example 6 becomes a PFFI, it will be required to provide information about its investors to the IRS; treating Foreign Holdco as an FFI would not add to that information. In addition, while one might argue that treating Foreign Holdco as an FFI may create an incentive for it to obtain and report information about its lenders, the same could be said in the case of any borrower that is a holding company in an active corporate group. Debt incurred by the operating subsidiaries in such a case would clearly be outside the scope of FATCA; and borrowing instead at a holding company level is typically done to facilitate commercial or financial objectives of the parties that are unrelated to FATCA (e.g., structural subordination to lenders of operating subsidiaries).[43]

We therefore recommend that only the investment fund in structures like Example 6 should be treated as an FFI, not portfolio holding companies like Foreign Holdco.

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[43] It could be argued that if Foreign Holdco in Example 6 is not treated as an FFI, then Foreign Fund may not have a particularly strong incentive to become a PFFI. Specifically, if Foreign Fund desired not to become a PFFI, it could hold all of its investments in U.S. stock or debt through foreign holding corporations like Foreign Holdco and could dispose of such investments by selling the shares of the foreign holding corporations. Gross proceeds from such sales generally would not be subject to FATCA withholding, even if Foreign Fund is not a PFFI.

However, such an argument does not provide strong support for treating Foreign Holdco as an FFI. If Foreign Holdco is not expected to receive significant withholdable payments or passthru payments from the Opcos for the duration of Foreign Fund's investment in Foreign Holdco (an issue within the sole control of Foreign Fund), then treating Foreign Holdco as an FFI would not seem to provide much incentive to cause either Foreign Holdco or Foreign Fund to become a PFFI. A more effective approach to the problem of ensuring that Foreign Fund has the proper incentive to become a PFFI might be to deem any proceeds from any sale by Foreign Fund of the stock of Foreign Holdco to be a withholdable payment in any case where it appears that the primary purpose of Foreign Holdco is to allow Foreign Fund to avoid receiving payments that would otherwise be subject to withholding (for example, in a case where Foreign Fund is a nonparticipating FFI and substantially all of Foreign Holdco's assets consist of U.S. stock or debt).

4. If recommendation 2 is not accepted, then several of the proposed categories of excepted FFIs (those for a nonfinancial holding company, a company emerging from reorganization or bankruptcy, and a hedging or finance center) should be clarified.

If, notwithstanding our proposal in recommendation 2 above to test companies on a group basis for status as excepted FFIs, the categories of excepted FFIs set forth in the Proposed Regulations are all retained, then we recommend clarifications to the mechanical requirements for several of those categories.

a. Time Period for Measuring Status as an Excepted FFI

The definitions of a nonfinancial holding company, start-up company and hedging/financing center in Proposed Regulations sections 1.1471-5(e)(5)(i), (ii) and (iv) do not specify a time period during which the requirements for each of those categories must be met. We recommend that a fixed time period be specified for each exception; and for nonfinancial holding companies and hedging/financing centers, we recommend that the time period be longer than one year, to lessen the significance of temporary swings in the composition of an entity's income and assets. We also suggest that the relevant time period end before the start of the year in which the entity will act on its finding of excepted FFI or non-excepted FFI status, so that an entity can make an informed choice. Finally, we recommend that once a determination has been made whether an entity is an excepted FFI, no re-testing would occur until at least the beginning of the next year.

b. Nonfinancial Holding Companies

It would be appropriate to revise the definition of a nonfinancial holding company in a manner that avoids apparently unintended results like those in Examples 1 through 5 above. One possibility would be to apply a "look-through" rule for a holding company similar to those appearing elsewhere in the Code.[44]

c. Entities That Are Reorganizing, Liquidating or Emerging from Bankruptcy

The Proposed Regulations contain a caption referring to an entity emerging from "reorganization or bankruptcy" as a type of excepted NFFE. However, the Proposed Regulation itself does not refer to bankruptcy and also does not explain what is required for an entity to be "reorganizing". We recommend that the definition refer to (1) being the debtor in a bankruptcy or insolvency proceeding presided over by a court or by an administrator appointed under local insolvency laws, and/or (2) disposing of a historic business either with the intent to liquidate

[44] *See* notes 31 and 32 above.

reasonably promptly afterward, or with the intent to use at least a substantial portion of the proceeds to create or acquire a new business.

In addition, the regulation requires that the entity "was not a financial institution under this paragraph (e) in the last 5 years."[45] We believe this is intended to require that (i) at some time in the 5-year period ending before the current year, the entity was not a financial institution within the basic definition of "financial institution" in the Proposed Regulations (disregarding the exceptions to that definition) and (ii) since the time the entity first became a financial institution during the last 5 years, it has continuously been in liquidation, in a bankruptcy or insolvency proceeding, or disposing of its old business and acquiring a new one. However, it would be helpful to clarify this.

d. Hedging/Financing Centers

The Proposed Regulations refer to a foreign entity that "primarily engages" in financing or hedging transactions with or for members of its expanded affiliated group that are not financial institutions.[46] Since this test resembles the test for whether an entity is "engaged primarily" in the business of investing (and thus is an Investment FFI), it would be appropriate to provide a similar testing period (three years) and measuring criterion (50% of gross income during the testing period) for determining whether an entity is primarily engaged in financing or hedging transactions. Also, it would be helpful to clarify what constitutes a "financing transaction". Presumably a loan of cash qualifies, but it is not clear whether grant of temporary rights to use other property (for example, real or personal property under a lease or an intangible under a license) qualifies; and it also is not clear whether equity financing qualifies. Furthermore, the Proposed Regulations require that the entity in question must not provide "financing or hedging services" to non-members of the expanded affiliated group. Presumably, the concept of "hedging services" connotes entering into such transactions with customers as a result of the entity holding itself out as ready to provide such hedges to third parties, as distinguished from simply entering into third-party hedges of exposure that the entity incurs in its group financing function. Similarly, the concept of "financial services" appears to connote a business of lending to third parties rather than, for example, making isolated loans of surplus cash. It would be helpful to clarify these points. Finally, the criteria for determining whether a hedging/financing company's expanded affiliated group is "primarily engaged in a business other than that of a financial institution" should also be clarified.

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[45] Prop. Reg. § 1.1471-5(e)(5)(iii).

[46] The Proposed Regulations define a hedging/financing center of a nonfinancial group as "a foreign entity that primarily engages in financing and hedging transactions with or for members of its expanded affiliated group that are not financial institutions and that does not provide financing or hedging services to non-affiliates, provided that the expanded affiliated group is primarily engaged in a business other than that of a financial institution." Prop. Reg. § 1.1471-5(e)(5)(iv).

III. Deemed-Compliant FFIs

A. Background

1. Deemed-Compliant FFIs

Deemed-compliant FFIs are exempt from withholding under Sections 1471 and 1472. The Proposed Regulations set forth a few broad categories of deemed-compliant FFIs: "registered" deemed-compliant FFIs, "certified" deemed-compliant FFIs, and "owner-documented FFIs," as well as FFIs that may in the future be described in guidance. The Preamble states that the deemed-compliant characterization "is intended to focus the application of chapter 4's obligations on financial institutions that provide services to the global investment community and reduce or eliminate burdens on truly local entities and other entities for which entering into an FFI agreement is not necessary to carry out the purposes of chapter 4."[47]

a. Registered Deemed-Compliant FFIs

The Proposed Regulations describe four categories of registered deemed-compliant FFIs, each of which must satisfy several specific requirements concerning its legal, regulatory and commercial characteristics in order to achieve deemed-compliant status. These include: (1) a local FFI (an FFI that principally has account holders in the country where it is established)[48]; (2) a nonreporting member of a PFFI group (an FFI that verifies it does not and will not have U.S. account holders)[49]; (3) a qualified collective investment vehicle (an investment fund held only by

47 Preamble, 77 Fed. Reg. at 9025.

48 The requirements for qualifying as a local FFI are as follows: the FFI, and each affiliate FFI (if any), must (i) not be an FFI merely because it is an Investment FFI; (ii) be organized in a FATF-compliant country; (iii) be licensed and regulated under local laws as a bank, securities broker or dealer, or investment advisor; (iv) not have a fixed place of business outside of its home country; (v) not solicit account holders outside of its home country; (vi) be required to perform either information reporting or withholding on accounts held by residents, (vii) have at least 98% of its accounts held by residents; (viii) have procedures to ensure that it does not open or maintain accounts for any specified U.S. person who is not a resident in its home country, a nonparticipating FFI, or any entity controlled or beneficially owned by a specified U.S. person; and (ix) review pre-existing accounts of individual non-residents. Prop. Reg. § 1.1471-5(f)(1)(i)(A).

49 The requirements for qualifying as a nonreporting member of a PFFI group are as follows: the FFI must (i) review its preexisting accounts to identify any U.S. accounts or nonparticipating FFI accounts; (ii) within 90 days of identifying any such account, transfer the account to an affiliate that is a PFFI or a U.S. financial institution, close the account, or enter into an FFI agreement; (iii) have procedures to ensure that if the FFI opens a U.S. account or a nonparticipating FFI account the FFI will become a PFFI or transfer the account to an affiliate that is a PFFI or a U.S. financial institution; and (iv) have procedures to ensure that if the FFI has knowledge that an account becomes a U.S. account or a nonparticipating FFI account, the FFI will become a PFFI or transfer the account to an affiliate that is a PFFI or a U.S. financial institution. Prop. Reg. § 1.1471-5(f)(1)(i)(B).

non-specified U.S. persons, PFFIs or deemed-compliant FFIs)[50]; and (4) a restricted fund (an investment fund held only by persons that are not U.S. persons, entities with substantial U.S. owners, or nonparticipating FFIs).[51] In addition, the Proposed Regulations contemplate other categories of registered deemed-compliant FFIs, including FFIs identified in a FATCA implementation agreement between the United States and a foreign country.

A registered deemed-compliant FFI generally is required to register as such with the IRS and attest to the IRS that it satisfies certain procedural requirements. In addition, a registered deemed-compliant FFI has certain continuing obligations, including the renewal of its certification every three years, an obligation to notify the IRS if it ceases to qualify for its registered deemed-compliant status, and to notify the IRS and re-register if it is merged into or is acquired by a PFFI or PFFI group.[52]

An FFI will not qualify for registered deemed-compliant status if any member of its expanded affiliated group is an FFI that is not either a PFFI or registered deemed-compliant FFI (or before 2016, a limited FFI).[53]

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[50] The requirements for qualifying as a qualified collective investment vehicle are as follows: the FFI, and all affiliated FFIs (if any), must (i) not be an FFI solely as an Investment FFI and not constitute a banking, custodial or insurance FFI; (ii) be regulated as an investment fund under local law; and (iii) only have debt interests in excess of $50,000 or equity interests that are held by PFFIs, registered deemed-compliant FFIs, U.S. persons that are not specified U.S. persons, and/or exempt beneficial owners. Prop. Reg. § 1.1471-5(f)(1)(i)(C).

[51] The requirements for qualifying as a restricted fund are as follows: the FFI, and such affiliated FFI (if any), must (i) be solely an Investment FFI and not constitute a banking, custodial, or insurance FFI; (ii) be organized in a FATF-compliant country; (iii) be regulated as an investment fund under local law; (iv) be sold only through "restricted distributors" or redeemed solely by the FFI; (v) have distributors that are PFFIs, registered deemed-compliant FFIs, "nonregistering local banks" or a "restricted distributor" (each as described below); (vi) ensure that distribution agreements for its debt or equity interests prohibit sales to U.S. persons, nonparticipating FFIs, or passive NFFEs with one or more substantial U.S. owners; (vii) indicate in all prospectus and marketing materials that sales to U.S. persons, nonparticipating FFIs, or NFFEs with one or more substantial U.S. owners are prohibited; (viii) ensure that each distribution agreement of its debt or equity interests requires the distributor to notify the FFI of a change in the distributor's status; (ix) certify to the IRS that it will terminate any distribution agreement if a distributor ceases to meet these requirements and will redeem any interests it issued through the distributor; (x) review preexisting accounts to identify U.S. accounts or nonparticipating FFI accounts; and (xi) implement procedures to ensure that it does not open or maintain accounts for any specified U.S. person, nonparticipating FFI, or passive NFFE with one or more substantial U.S. owners. Prop. Reg. § 1.1471-5(f)(1)(i)(D).

[52] Prop. Reg. § 1.1471-5(f)(1)(ii).

[53] It would seem logical for this list to include limited FFIs as well. However, a limited FFI is an entity that has at least one PFFI in its expanded affiliated group. Prop. Reg. § 1.1471-4(e)(3)(ii). Under the current definition, it is not enough to have only one or more registered deemed-compliant FFIs in the expanded affiliated group.

b. Certified Deemed-Compliant FFIs

In contrast to registered deemed-compliant FFIs, there are no IRS registration requirements for certified deemed-compliant FFIs. The Proposed Regulations provide for several types of certified deemed-compliant FFIs, each of which is required to possess particular legal and commercial characteristics: (1) a nonregistering local bank (a small bank with offices solely in the country where it is established)[54]; (2) a retirement fund that has a relatively large group of beneficiaries, each of whom has a small (5% or less) proportionate interest in the retirement fund (a "**Broad-Based Retirement Fund**"), where the fund meets certain requirements[55]; (3) a retirement fund in which a smaller group of beneficiaries may each hold a substantial (over 5%) interest (a "**Narrow-Based Retirement Fund**"), provided that the fund meets a more strict set of requirements[56]; (4) a non-profit organization[57]; and (5) an FFI with only low-value accounts.[58]

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[54] The requirements for qualifying as a nonregistering local bank are as follows: the FFI must, and any affiliated FFI (if any), (i) operate and be licensed solely as a bank in its country of organization; (ii) be licensed to conduct business in its home country; (iii) have no fixed place of business outside of its home country; (iv) not solicit outside of its home country; (v) have no more than $175 million of assets on its balance sheet; and (vi) be required to perform either information reporting or withholding with respect to resident accounts under local law. Prop. Reg. § 1.1471-5(f)(2)(i).

[55] The requirements for a Broad-Based Retirement Fund are as follows: (i) the FFI is organized to provide retirement or pension benefits under local law in the country in which it is established or operates; (ii) all contributions to the FFI (other than transfers of assets from other exempt retirement accounts, funds or plans) are employer, government, or employee contributions that are limited by reference to earned income; (iii) no single beneficiary has a right to more than five percent of the FFI's assets; and (iv) one of the following requirements is satisfied (A) contributions to the FFI are deductible or excluded from gross income of the beneficiary; (B) the taxation of investment income attributable to the beneficiary is deferred under the local law; or (C) 50 percent or more of the total contributions to the FFI are from the government and the employer. Prop. Reg. § 1.1471-5(f)(2)(ii)(1).

[56] The requirements for a Narrow-Based Retirement Fund are as follows: (i) the FFI is organized to provide retirement or pension benefits under local law in the country in which it is established or operates; (ii) it has fewer than 20 participants; (iii) it is sponsored by an employer that is not an Investment FFI or a passive NFFE; (iv) contribution the FFI are limited by reference to earned income; (v) participants that are not residents of the country in which the FFI is organized are not entitled to more than 20 percent of the FFI's assets; and (vi) No participant that is not a resident of the country in which the FFI is organized is entitled to more than $250,000 of the FFI's assets. Prop. Reg. § 1.1471-5(f)(2)(ii)(2).

[57] The requirements for qualifying as a non-profit organization are as follows: (i) the FFI is established and maintained in its country of residence exclusively for religious, charitable, scientific, artistic, cultural or educational purposes; (ii) the FFI is exempt from income tax in its country of residence; (iii) the FFI has no shareholders or members who have a proprietary or beneficial interest in its income or assets; (iv) income or assets of the FFI cannot be distributed to, or applied for the benefit of, a private person or noncharitable FFI; and (v) upon the FFI's

c. Owner-Documented FFIs

Generally, an owner-documented FFI is an Investment FFI that meets certain limits on its borrowing activity and its affiliation with other FFIs.[59] An owner-documented FFI is treated as a deemed-compliant FFI with respect to payments received by and accounts held with a withholding agent that agrees to undertake specific due diligence and reporting requirements in respect of the owners of the owner-documented FFI.[60] An owner-documented FFI will only be treated as a deemed-compliant FFI with respect to a payment or account for which it does not act as an intermediary.

2. Exempt Beneficial Owners

In addition to identifying the above categories of deemed-compliant FFIs, the Proposed Regulations also describe six categories of exempt beneficial owners: (1) foreign governments and certain controlled entities; (2) international organizations; (3) foreign central banks; (4) governments of U.S. possessions; (5) certain retirement funds; and (6) entities wholly owned by one or more exempt beneficial owners.[61]

Exempt beneficial owners are exempt from withholding under Sections 1471 and 1472. Moreover, accounts that are held solely by exempt beneficial owners are not treated as financial accounts for purposes of the Proposed Regulations, and accordingly are excluded from the due diligence, reporting and withholding obligations of PFFIs.[62] The Proposed Regulations also

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liquidation or dissolution, all of its assets must be distributed to either a foreign governmental entity that would qualify as an exempt beneficial owner, or another qualifying non-profit organization, or escheat to the government. Prop. Reg. § 1.1471-5(f)(2)(iii).

58 The requirements for qualifying as an FFI with only low-value accounts are as follows: (i) the FFI must be treated as an FFI only as a banking-type FFI and/or a custodial-type FFI and is not an Investment FFI or insurance FFI; (ii) no financial account maintained by the FFI has a balance or value in excess of $50,000; (iii) the FFI must have no more than $50 million in assets on its balance sheet; and (iv) if the FFI is a member of an expanded affiliated group, the entire expanded affiliated group must have no more than $50 million in assets on its consolidated or combined balance sheet. Prop. Reg. § 1.1471-5(f)(2)(iv).

59 It must not be affiliated with banking-type FFIs, custodial-type FFIs or insurance-type FFIs and must not maintain a financial account for any nonparticipating FFI or issue debt which constitutes a financial account to any person in excess of $50,000. Prop. Reg. §§ 1.1471-5(f)(3)(ii)(B), (C).

60 The withholding agent will be required to report with respect to each specified U.S. person that has a direct or indirect interest in the owner-documented FFI (i) the name of the owner-documented FFI; (ii) the name of the specified U.S. person; (iii) the TIN or EIN of the specified U.S. person; (iv) the address of the specified U.S. person; and (v) any other information required on the relevant form and instructions. *See* Prop. Reg. §§ 1.1471-3(d)(7), 1.1474-1(i).

61 Prop. Reg. §§ 1.1471-6(b)-(g).

62 Prop. Reg. § 1.1471-5(b)(2)(iii).

apply these exemptions to accounts held by a nonparticipating FFI to the extent they are acting as an intermediary or as a flow-through entity for the benefit of one or more exempt beneficial owners, provided that certain documentation requirements are satisfied.[63]

B. Summary of Recommendations

1. Final regulations should broaden the category of persons that can qualify as "owner-documented" FFIs, especially by making it easier for family-owned investment vehicles to qualify.

2. Treasury and the IRS should clarify the procedures for registration of registered deemed-compliant FFIs.

3. Any FFI, and not just certain Investment FFIs, should be able to qualify as a registered deemed-compliant FFI if all of its accounts (other than accounts with a value of less than $50,000) are held by PFFIs, registered deemed-compliant FFIs, and certain other exempt persons.

4. An FFI should be allowed to register as a deemed-compliant FFI if it is organized in a FATF-compliant country, undertakes due diligence to ascertain whether any of its account holders are specified U.S. persons or nonparticipating FFIs, and meets certain other requirements. This new category of registered deemed-compliant FFIs would replace both the local FFI and the restricted fund categories of registered deemed-compliant FFIs.

5. If recommendation 4 is not accepted, we recommend several changes to the definitions of local FFI and restricted fund in the Proposed Regulations.

6. Certified deemed-compliant treatment of nonregistering local banks and FFIs with low-value accounts should be broadened to cover a wider range of small, local entities.

7. Final regulations should simplify and clarify in a number of respects the treatment of Broad-Based Retirement Funds. So long as such a fund meets requirements establishing it is a bona fide retirement or pension vehicle, it should be exempted from Section 1471 withholding regardless of whether it is treated for U.S. tax purposes as a grantor trust.

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[63] Prop. Reg. § 1.1471-5(b)(2)(iii). The Proposed Regulations do not expressly address the outcome in the reverse scenario – where an entity that qualifies as an exempt beneficial owner receives a payment as an agent or intermediary on behalf of some other person that does not qualify. Although not entirely clear, it appears that with respect to such a payment, the intermediary entity would be treated as (depending on the facts) either a normal FFI or an NFFE for purposes of the withholding rules under chapter 4. *Cf.* Prop. Reg. § 1.1471-6(f)(2), Example 3 (as discussed further in Part III.C.7 below, a Broad-Based Retirement Fund that is an "investment conduit" for participating employees would not qualify as an exempt beneficial owner; instead, it is subject to potential treatment as a certified deemed-compliant FFI).

8. Final regulations should increase the number of allowable participants in a Narrow-Based Retirement Fund and relax the limits on the number of those participants that may be non-residents of the country where the fund is organized. Final regulations should also allow the employees of an Investment FFI to be covered by a Narrow-Based Retirement Fund.

9. Final regulations should create a new category of exempt beneficial owner: a treaty-qualified non-profit organization.

C. Discussion

Comments on Owner-Documented FFIs (Recommendation 1)

1. Final regulations should broaden the category of persons that can qualify as "owner-documented" FFIs, especially by making it easier for family-owned investment vehicles to qualify.

The Proposed Regulations limit the definition of owner-documented FFIs to Investment FFIs.[64] In addition, in order to qualify as an owner-documented FFI, the FFI must not maintain a financial account for any nonparticipating FFI or issue debt which constitutes a financial account to any person in excess of $50,000.[65] This effectively precludes owner-documented FFI status for any FFI that borrows money from a nonparticipating FFI or borrows in excess of $50,000 from any person.[66] We recommend that final regulations relax these requirements in several respects, principally so that the owner-documented FFI rules can better achieve their apparent purpose of providing relief to smaller family-owned vehicles.

It is possible that the rationale for limiting the concept of an owner-documented FFI to Investment FFIs was to prohibit the inappropriate use of this category as a substitute for PFFI status. However, we question how the policy objectives of FATCA would be harmed in a case where a non-Investment FFI (e.g., an investment advisor or a trust company holding financial assets for account holders) agrees to gather and transmit the U.S. tax documentation for each of its account holders to a withholding agent that agrees to assume reporting and withholding responsibility in respect of such account holders. In such a situation, absent fraudulent behavior, information regarding every account holder of the FFI will be properly provided and reported

64 Prop. Reg. § 1.1471-5(f)(3)(ii)(A).

65 Prop. Reg. § 1.1471-5(f)(3)(ii)(C).

66 Any non-regularly traded debt instrument issued by an FFI described only in Proposed Regulations section 1.1471-5(e)(1)(iii) is a "financial account" under Proposed Regulations section 1.1471-5(b)(1)(iii), assuming such debt is not owned by an exempt beneficial owner. Even if there were no such definitional restriction, payments of interest on loans from nonparticipating FFIs would be treated as passthru-payments subject to future withholding.

under FATCA. Accordingly, we recommend that final regulations extend the principle of owner-documented FFIs to all types of FFIs.

In addition, we propose that an owner-documented FFI be allowed to borrow without limitation as to amount, so long as it can establish that the lender is not a nonparticipating FFI. As noted above, we understand that the owner-documented FFI category was intended, in large part, to provide relief to family-held investment vehicles.[67] Such entities very often hold leveraged investments, but under the Proposed Regulations, any such entity that has debt outstanding would fail to qualify.[68] The prohibition on debt would thus exclude a large portion of the intended universe of beneficiaries of the intended relief. Moreover, assuming that the lender provides the appropriate withholding certificates to the owner-documented FFI, we do not view such verification to be more complex or problematic than verifying the owners of the FFI. Accordingly, we recommend that final regulations permit an owner-documented FFI to have debt outstanding that is held by persons other than nonparticipating FFIs.

In addition, the owner-documented FFI definition only applies to payments received from a withholding agent that is a U.S. financial institution or a PFFI. Thus, the owner-documented FFI rules would not appear to provide protection for payments received from a U.S. nonfinancial company in which the would-be owner-documented FFI owns an interest directly without an intervening financial institution intermediary. There is no obvious policy reason why the class of permissible withholding agents should be limited in this way.

Furthermore, although it is not clear this is intended, the Proposed Regulations appear to preclude an FFI from qualifying as an owner-documented FFI, where the FFI owns an interest in another FFI that also seeks to qualify as an owner-documented FFI (e.g., where a foreign family trust or holding company is owned by another foreign family trust). Under the Proposed Regulations, the upper-tier FFI can qualify as an owner-documented FFI only with respect to payments it receives from a designated withholding agent. However, if the upper-tier FFI receives payments from the lower-tier FFI, it appears this requirement will not be met: the parties will likely find it undesirable or impractical for the lower-tier FFI to take on the necessary withholding and reporting burden, which indeed is precisely what the owner-documented FFI regime is meant to avoid.[69] We recommend that final regulations clarify that as long as a

67 *See* Notice 2010-60, 2010-37 I.R.B. 329, 332.

68 We note, however, that a family-owned vehicle that holds equity of a leveraged entity, instead of directly holding an investment and incurring the related borrowing, would apparently not run afoul of the prohibition against the family-owned vehicle incurring debt.

69 In such a case, if the upper-tier FFI does not qualify as an owner-documented FFI, that would appear to prevent the lower-tier FFI from qualifying as well. It appears that an FFI can qualify as an owner-documented FFI only if it is not affiliated with any other FFIs, save for owner-documented FFIs. *See* Prop. Reg. § 1.1471-3(d)(7)(i)(F).

designated withholding agent reports on all the direct and indirect specified U.S. persons in the ownership chain, both the FFI receiving payments directly from that withholding agent and each upper-tier FFI in the ownership chain can be treated as owner-documented FFIs.

Finally, we propose that the documentation requirements for an owner-documented FFI be scaled back. The Proposed Regulations require an FFI to provide to each withholding agent documentation as to most or all of the persons that hold, directly or indirectly, interests in the FFI; and the FFI also is required to make an annual certification to each withholding agent with information about each person that owns an equity interest in the FFI.[70] In lieu of these documents, the Proposed Regulations allow the FFI to provide (generally annually) a letter from an accounting or law firm with a U.S. office confirming that no owner of a direct or indirect interest in the FFI is a nonparticipating FFI, specified U.S. person or passive NFFE with substantial U.S. owners.[71] We believe that instead of having to satisfy these requirements, it would be reasonable to allow at least some smaller FFIs to obtain documentation only with respect to each direct or indirect owner of a material percentage (by value) of their equity interests. It also would be reasonable for an FFI to have to provide a certification (or a letter from a law or accounting firm) to withholding agents only once every few years, absent a known change in circumstances.[72] We believe these modifications would make it easier for family-owned and similar vehicles that lack the resources and systems for an expansive compliance exercise to meet the documentation requirements that apply to owner-documented FFIs.

If our recommendations described above are not accepted, we believe that many of the types of vehicles which are within the intended scope of the owner-documented FFI rules will in fact not be permitted to avail themselves of these rules. In that event, we would suggest that Treasury and the IRS consider other alternatives to address this issue, such as creating a new category of deemed-compliant FFI that is expressly tailored to family-owned investment vehicles. For example, an Investment FFI could qualify as deemed-compliant if it has net assets below a specified threshold and has equity interests that are exclusively or almost exclusively owned by members of a family (defined broadly to include several generations of individuals that share a common ancestor, as well as their spouses and adoptive children).

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70 Prop. Reg. § 1.1471-3(d)(7)(i)(C), (i)(D), (iii), (iv).

71 Prop. Reg. § 1.1471-3(d)(7)(ii).

72 *Cf.* Prop. Reg. § 1.1471-3(c)(6)(ii)(A) (cross-referencing Treasury Regulation section 1.1441-1(e)(4)(ii)(A)-(C), and thus generally providing for a 3-year validity period and in some cases an indefinite validity period for a withholding certification).

Comments on Registered Deemed-Compliant FFIs (Recommendations 2-5)

2. Treasury and the IRS should clarify the procedures for registration of registered deemed-compliant FFIs.

We applaud the efforts of Treasury and the IRS to identify categories of FFIs that present less risk of U.S. tax avoidance and therefore allow them to qualify for relief from withholding under Section 1471 without satisfying the same requirements imposed on PFFIs.

We note that the Proposed Regulations do not address certain issues which have a bearing on the utility of creating multiple categories of deemed-compliant FFIs. In particular, we encourage Treasury and the IRS to clarify whether the registration process for registered deemed-compliant FFIs will require the submission of supporting documentation, the type of verification procedures that will apply to registered deemed-compliant FFIs, and the extent to which a registered deemed-compliant FFI will become subject to the jurisdiction of the IRS for matters unrelated to its status as a registered deemed-compliant FFI. If becoming a registered FFI is a quick and efficient process, it may eliminate the need for separate categories of certified deemed-compliant FFIs subject to different requirements. Eliminating this separate category should also increase the ease and simplicity of complying with FATCA for these entities.

3. Any FFI, and not just certain Investment FFIs, should be entitled to register as a deemed-compliant FFI if all of its accounts (other than accounts with a value of less than $50,000) are held by PFFIs, registered deemed-compliant FFIs, and certain other exempt persons.

We note that an Investment FFI will generally qualify as a deemed-compliant FFI, if all of its accounts with a value in excess of $50,000 are held by PFFIs, registered deemed-compliant FFIs, and certain other exempt persons.[73]

We believe that any FFI, and not just certain Investment FFIs, should be permitted to qualify as a deemed-compliant FFI if all of its accounts above the $50,000 *de minimis* threshold are held by persons exempt from FATCA withholding. There are many types of entities, such as wholesale banks, clearing organizations, investment advisors, trust companies, certain custodians, and reinsurers, that deal exclusively with other financial institutions and that may be willing to limit their account relationships to PFFIs, registered deemed-compliant FFIs, and certain other exempt persons.[74] We see no reason to require such entities to spend the time and resources of

[73] Such an Investment FFI will qualify under the Proposed Regulations as a qualified collective investment vehicle. *See* Prop. Reg. § 1.1471-5(f)(1)(i)(C).

[74] In particular, it would seem appropriate to permit any exempt beneficial owner to have an account with such an FFI; we suggest that Treasury and the IRS also allow any certified deemed-compliant FFI to have an account with such an FFI as well. Certain important types of institutional investors, including pension funds and not-for-profit organizations, are not eligible to be treated as registered-deemed compliant FFIs under the Proposed

becoming PFFIs and can identify no policy basis for distinguishing such entities from Investment FFIs with the same investor base.[75]

> ***4. An FFI should be allowed to register as a deemed-compliant FFI if it is organized in a FATF-compliant country, undertakes due diligence to ascertain whether any of its account holders are specified U.S. persons or nonparticipating FFIs, and meets certain other requirements. This new category of registered deemed-compliant FFIs would replace both the local FFI and the restricted fund categories of registered deemed-compliant FFIs.***

We believe that final regulations should eliminate local FFIs and restricted funds as separate categories of registered deemed-compliant FFIs and replace them with a single new category consisting of FFIs that meet the following key requirements of the Proposed Regulations:

- organization in an FATF-compliant jurisdiction;[76]
- application of a local regulatory regime (e.g., a bank, broker, dealer, investment adviser or financial planner, or investment fund);[77]
- an obligation to perform due diligence to ascertain whether any existing account holders are specified U.S. persons (directly or holding through passive NFFEs) or nonparticipating FFIs, at the time the FFIs register for deemed-compliant FFI status;[78]
- procedures to ensure on a going-forward basis that persons that hold accounts are not specified U.S. persons (directly or holding through passive NFFEs) or nonparticipating FFIs, including closing or transferring of existing accounts (such

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Regulations. These investors cannot hold an account with a deemed-compliant FFI described in Proposed Regulations section 1471-5(f)(1)(i)(C) unless they become PFFIs. We do not believe requiring them to do so serves any important policy objectives of the chapter 4 regime.

75 In Part VIII.C.9, we recommend that clearing systems be specifically granted deemed-compliant status, at least on a transitional basis. If our recommendation above in Part III.C.3 is accepted, then a clearing system that has account holders that are limited to PFFIs, registered deemed-compliant FFIs and certain other exempt persons would continue to be able to qualify as a deemed-compliant FFI after any transitional relief expires.

76 Prop. Reg. §§ 1.1471-5(f)(1)(i)(A)(1) and (D)(1).

77 Prop. Reg. §§ 1.1471-5(f)(1)(i)(A)(1) and (D)(1).

78 Prop. Reg. §§ 1.1471-5(f)(1)(i)(A)(7) and (D)(6).

procedures may apply at the level of the FFI or at the level of distributors of financial accounts with the FFI);[79] and

- no affiliation with other FFIs, except for PFFIs, deemed-compliant FFIs, limited FFIs until 2016 and (if our recommendation in Part IV.C.13 is adopted) exempt beneficial owners.[80]

The other requirements under the Proposed Regulations for entities in one or both of these two categories are secondary and, in our view, of far less significance to achieving the policy objectives of FATCA:

- lack of international presence;[81]
- lack of international solicitation;[82]
- possibility of distribution by a distributor that is not a PFFI or a registered deemed-compliant FFI, provided that the distributor is a small, local institution;[83]
- limited international account holder base;[84]
- local tax reporting or withholding obligations in respect of account holders;[85] and
- absence of affiliation with other types of participating or deemed-compliant FFIs.[86]

In our view, the five key requirements listed above should provide sufficient safeguards against the possibility that an FFI or its affiliates will have account holders that are specified U.S. persons or nonparticipating FFIs. These five requirements tend to identify an FFI that is already subject to regulatory and FATF obligations in its home country which generally provide a solid

79 *See* Prop. Reg. §§ 1.1471-5(f)(1)(i)(A) and (D).

80 Prop. Reg. §§ 1.1471-5(f)(1)(i)(A)(8) and (D)(7).

81 Local FFIs; restricted distributor distributing on behalf of a restricted fund. Prop. Reg. §§ 1.1471-5(f)(1)(i)(A)(2) and (D)(1).

82 Local FFIs; restricted distributor distributing on behalf of a restricted fund. Prop. Reg. §§ 1.1471-5(f)(1)(i)(A)(3) and (D)(1).

83 Restricted fund. Prop. Reg. §§ 1.1471-5(f)(1)(i)(D)(2) and (f)(4).

84 Local FFIs. Prop. Reg. § 1.1471-5(f)(1)(i)(A)(5).

85 Local FFIs. Prop. Reg. § 1.1471-5(f)(1)(i)(A)(4).

86 Local FFIs may only affiliate with other local FFIs in the same country; and a restricted distributor distributing on behalf of a restricted fund may only have same-country affiliates. Prop. Reg. §§ 1.1471-5(f)(1)(i)(A)(8) and (D)(7).

foundation for complying with the diligence obligations imposed under FATCA and the related procedures for identifying account holders that are specified U.S. persons or nonparticipating FFIs.[87]

We do not believe that having an international presence, engaging in international solicitation, or having an international account holder base is a particularly strong indicator of the likelihood that an FFI (or its distributor) will have account holders that are specified U.S. persons, passive NFFEs with substantial U.S. owners, or nonparticipating FFIs. In particular, we do not believe that the local nature of an institution's operations is a particularly good indicator of the strength of its procedures for excluding such account holders. Indeed, the fact that FFIs and distributors operating internationally are required to account for multiple legal and regulatory regimes suggests that such institutions may have stronger systems and be better able to identify and exclude such account holders.

We also do not believe that the condition that certain registered deemed-compliant FFIs be subject to local tax reporting or withholding obligations in respect of account holders substantially assists in ensuring that the FFI has no account holders that are specified U.S. persons, passive NFFEs with substantial U.S. owners, or nonparticipating FFIs. We assume that the purpose of this condition is to increase the likelihood that the IRS will be able to verify the absence of such account holders through requests for information addressed to the relevant government. However, local tax reporting information might not always be available to the IRS. There are a number of FATF-compliant countries with no information exchange agreement with the United States. In addition, neither the information exchange provisions in the U.S. Model Income Tax Convention nor the standard form of information exchange agreement would entitle the IRS to indiscriminate access to local tax reporting by a registered deemed-compliant FFI. In addition, assuming that local tax information is furnished to the IRS, we question how useful it will be in identifying the relevant account holders, particularly if the local tax rules require the FFI to report information only in respect of residents of the relevant country.[88]

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[87] In the case of an FFI that is a fund with interests that are distributed to investors, we anticipate that final regulations will require that the distributors of such interests must be PFFIs, deemed-compliant FFIs, or entities that are exempt beneficial owners.

[88] In this regard, we note that U.S. financial institutions generally have no reporting or withholding obligations to the IRS in respect of foreign source income, broker proceeds, and certain categories of U.S. source income paid to foreign account holders. *See* Treas. Reg. §§ 1.1461-1(b) and (c), 1.6042-3(b)(1)(iii), 1.6045-1(g)(1), 1.6049-5(b)(12). In addition, we note that even if an FFI is subject to local tax reporting requirements that extend to non-resident taxpayers, the information reported by the FFI may be of a type or in a format that is not particularly useful to the IRS. *See generally* Steven Dean, *The Incomplete Global Market for Tax Information*, 49 B.C. L. Rev. 605, 631-633, 635-637 (2008) (discussing limits on the usefulness of tax information shared by foreign governments with the United States).

However, under the five requirements recommended above for registered deemed-compliant status, an FFI would need to gather and review information about its account holders in order to determine whether any of them

Finally, we do not believe that the absence of affiliation with other specific types of participating or deemed-compliant FFIs substantially assists in ensuring that an FFI or its distributor does not have account holders that are specified U.S. persons, passive NFFEs with substantial U.S. owners, or nonparticipating FFIs.

Accordingly, we recommend that any FFI that meets the five requirements listed above be entitled to register as a deemed-compliant FFI. This broader category of deemed-compliant FFIs would subsume the local FFI and restricted fund categories, and would therefore eliminate the need for these categories. We believe this would simplify the FATCA regulations without compromising any of their key objectives.[89]

If, notwithstanding these recommendations, final regulations retain some or all of the specific categories of registered deemed-compliant FFIs set forth in the Proposed Regulations, then we respectfully request that the comments below in Part III.C.5 be taken into account when finalizing the regulations.

5. *If recommendation 4 is not accepted, we recommend several changes to the definitions of local FFI and restricted fund in the Proposed Regulations.*

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are held by specified U.S. persons (either directly or through a passive NFFE) or by nonparticipating FFIs. Treasury and the IRS may wish to consider what types of verification or IRS audit procedures should apply to FFIs that register to become deemed-compliant FFIs. Such procedures could potentially provide Treasury and the IRS with a more effective way of verifying the efforts of a deemed-compliant FFI to identify its U.S. account holders than reviewing local tax information reports.

We note that at least one of our members is of the view that the type of deemed-compliant FFI described in the text should be required to be subject to local tax reporting obligations, and perhaps also should be required to be in a country that has entered into a treaty or information exchange agreement with the United States. Under this view, such a rule would achieve several objectives. First, it would help to substantiate that the FFI is genuinely engaged in a financial services business in the relevant country (similar to the requirement described in the text for the FFI to be subject to a regulatory regime in that country). Second, in some cases it could be valuable to Treasury and the IRS to be able to obtain local tax reporting information about account holders. Finally, it may be more effective and efficient for Treasury and the IRS to obtain local tax reporting information using government-to-government procedures than to obtain the information by direct IRS audits of FFIs. (In regard to this last point, we believe that if a broader network of FATCA implementation agreements or other comprehensive information exchange arrangements develop over time, these may indeed be a promising way of obtaining information, including information that is more tailored to the needs of Treasury and the IRS.)

[89] In the interest of simplicity and administrability, we propose that at least in the case of reviewing holders of existing accounts at the time an FFI registers to become deemed-compliant, it should be permissible for a local FFI or restricted fund to rely only on a review of the data gathered in its AML/KYC diligence on account holders to identify specified U.S. persons (owning directly or through passive NFFEs) or nonparticipating FFIs, without a need to gather any additional information from account holders. (This diligence could be supplemented by an obligation for an FFI to perform additional diligence similar to that required of PFFIs, in the event the IRS requests that the FFI do so.)

a. A local FFI's advertisement on its website (or in local media) of U.S. dollar denominated deposits or other investments should not constitute the solicitation of account holders outside the FFI's country of incorporation or organization.

If our recommendation in Part III.C.4 above is not accepted, we believe that the definition of local FFI in the Proposed Regulations should be revised in several respects. First, the Proposed Regulations provide that a local FFI must not solicit account holders outside its country of incorporation or organization, and further state that an FFI will not be considered to have done such solicitation merely because it operates a website, provided that the website does not, among other things, advertise the availability of U.S. dollar denominated deposit accounts or other U.S. dollar denominated investments.[90] The Proposed Regulations do not expressly state whether such advertisements constitute the solicitation of account holders outside the FFI's country of incorporation or organization. However, an FFI with a website that is accessible outside its country and that contains U.S. dollar denominated deposits or other investments may be unwilling to make certifications under penalties of perjury on its registration form and on its withholding certificate that it satisfies the requirements for treatment as a local FFI, to the extent that in doing so, it represents that it does not solicit account holders outside its country of incorporation or organization.

It is not clear whether the objective of prohibiting advertisements of U.S. dollar denominated deposits and other investments on the FFI's website is to exclude FFIs that offer such investments, or merely to exclude those that advertise on their website the fact that they offer such investments. We believe that excluding FFIs merely because they offer U.S. dollar denominated investment products would have the practical effect of excluding many institutions that serve a strong local need for U.S. dollar denominated investments. This would include, for example, banks in countries that have weak local currencies (or that use the U.S. dollar as their official local currency) or that have economies based on the U.S. dollar, as well as brokerage firms that offer products to access the U.S. capital markets.[91]

We also question whether FFIs that serve such local investment needs by offering U.S. dollar denominated products could as a practical matter avoid disclosing such products in a way that might be viewed as advertising. For example, local regulations may require an FFI to post

90 Instead of focusing on the country of incorporation or organization of an FFI, it may be preferable to require instead that all of its branches be located in a single country and that it not solicit account holders who are residents of other countries. Logically, it should be irrelevant to the status of an FFI under FATCA whether it has all its branches in the country under whose laws it is incorporated or, instead, has located all of its branches in some other country, so long as all or substantially all of its customers are located in a single country.

91 The Proposed Regulations do not define the concept of U.S. dollar denominated investments, and therefore a cautious institution might potentially view any investment product that offers a meaningful exposure to the U.S. capital markets as being so denominated.

on its website the documentation for all its investment products, or corporate documentation that mentions such products. Moreover, we question whether prohibiting advertisements of such products on the FFI's website will be effective in preventing information about any such products from being widely disclosed on the internet by third parties such as consumer rating sites.

Accordingly, we recommend that final regulations clarify that the offering or advertisement on an FFI's website of U.S. dollar denominated deposits or other investments does not constitute the solicitation of account holders outside the FFI's country of incorporation or organization. Similarly, the advertisement of such accounts or investments through means other than a website (e.g., advertisements in printed media) should not be treated as a solicitation of account holders outside an FFI's country of incorporation or organization, so long as the distribution of such advertisements occurs only within such country.[92]

b. Final regulations should exclude from the requirement that a local FFI implement procedures to ensure that it does not open or maintain accounts for any nonparticipating FFI, or any entity controlled or beneficially owned by a specified U.S. person, accounts for entities that have active local operations or local ownership.

The requirement that a local FFI implement procedures to ensure that it does not open or maintain accounts for any nonparticipating FFI, or any entity controlled or beneficially owned by a specified U.S. person, has no exception for local entities, or for entities owned by specified U.S. persons who are local residents. Similarly, the requirement that at least 98% of the accounts be held by local residents does not take into account the possibility that a non-resident with a local office or branch might hold an account with the FFI.[93] As a practical matter, the result may well be to prevent many FFIs from qualifying as local FFIs. For example, if (contrary to our recommendation 1 above) the Proposed Regulations are not modified to facilitate treatment of family-owned investment vehicles as owner-documented FFIs, then the rule just described would exclude any brokerage firm or investment advisory firm with clients investing through family investment vehicles, unless each such vehicle became a PFFI. The definition of local FFI in the Proposed Regulations also would exclude the account of any local business entity that is owned by a locally resident U.S. citizen or green card holder, or (in a similar vein) a local branch of a foreign multinational. However, a local FFI is permitted to open accounts for U.S. individuals

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[92] Advertisements on television or radio programs directed primarily to the local population of the relevant country should not be treated for this purpose as distributed outside of the relevant country even if accessible by persons in nearby jurisdictions.

[93] We assume that the 98% requirement refers to a percentage of account balances at the date of registration, taking into account any changes to such percentage that are expected by the FFI at such time. If that is not how Treasury and the IRS intend this requirement to be applied, then there should be a clarification in final regulations.

who are residents of a foreign country. Accordingly, in the event our recommendation in Part III.C.4 above is not accepted, we recommend that the definition of a local FFI be revised to permit accounts of entities that have active local operations or that are owned and controlled exclusively by local residents.

c. The requirements for restricted fund status should be revised in a manner that reflects the fact that, after fund interests are initially issued to investors, it may be difficult to compel investors to transfer those interests only through a qualifying distributor or to redeem those interests.

One of the requirements for qualification as a restricted fund is that interests in the fund may only be sold through qualifying distributors or redeemed directly by the restricted fund.[94] Assuming that our recommendation in Part III.C.4 above is not accepted, we suggest that the Proposed Regulations be revised to require that all the distribution arrangements made by the fund or its sponsors be with qualifying distributors. As currently phrased, the sales limitation could be read to prohibit any holder of an interest in the fund from having the right under applicable law to sell that interest to another person. To certify its status as a restricted fund, therefore, an FFI would have to review the laws applicable to the sales of interests in every jurisdiction where a holder of an interest resides, or where the interest itself is located.

In addition, if a distributor ceases to be a qualifying distributor, the Proposed Regulations require a restricted fund to acquire or redeem all debt and equity interests of the fund issued through that distributor within six months of the distributor's change in status. We understand that requirement to apply to all interests in the fund that were distributed through the distributor (as opposed to interests that were distributed within six months of the distributor's change in status), and that the acquisition or redemption must occur within six months following the distributor's change in status.

The Proposed Regulations require the distributor to notify the fund within 90 days of its change in status. Assuming that the distributor does not provide earlier notice, the fund would have roughly three months from the date on which it is notified of the distributor's change in status to the date on which it would be required to acquire or redeem all the fund interests distributed through that distributor. Depending on the nature of the fund's assets, and the value of the fund interests distributed through the distributor, such a forced redemption could require the fund to quickly liquidate assets at unfavorable prices, thereby harming the fund and all of its investors.[95]

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[94] Prop. Reg. §§ 1.1471-5(f)(1)(i)(D)(1).

[95] In addition, a loss of qualifying status by the distributor has no bearing on whether proper due diligence and controls were in place at the time of the original sale of fund interests by the distributor.

Instead, our proposed approach to the case of a distributor that ceases to be a qualifying distributor would be to provide in the distribution agreement that such a distributor must freeze its customers' fund interests by permitting only redemptions, subscriptions through dividend or distribution reinvestment plans that an investor has previously entered into, transfers to qualifying distributors, and conversions to direct interest holdings in the fund.

d. Final regulations should incorporate the definition of "U.S. persons" under Regulation S, for purposes of the rule stating that a restricted fund does not have to review its pre-existing direct accounts in accordance with the procedures applicable to PFFIs if its prospectus and distribution agreements prohibited sales to U.S. persons.

A restricted fund must review its pre-existing direct accounts in accordance with the procedures applicable to PFFIs, provided that the fund will not be required to review the account of any individual investor who purchased his or her interest at a time when all of the FFI's distribution agreements and its prospectus contained an explicit prohibition on the issuance of shares to U.S. entities and U.S. resident individuals.[96] Non-U.S. funds frequently include prohibitions against the sale of fund interests to "U.S. persons" within the meaning of Regulation S of the Securities Act of 1933. That definition generally covers U.S. entities and U.S. resident individuals. However, there are some circumstances where a U.S. entity will not be covered by the Regulation S definition.[97] Accordingly, a fund that had based its prohibition on the Regulation S definition of U.S. person may not be able to rely on this exception. Therefore, in the event our recommendation in Part III.C.4 above is not accepted and the concept of a restricted fund is retained in final regulations, we recommend that final regulations specifically incorporate the definition of U.S. persons under Regulation S.[98]

Comments on Certified Deemed-Compliant FFIs (Recommendations 6-8)

6. Certified deemed-compliant treatment of nonregistering local banks and FFIs with low-value accounts should be broadened to cover a wider range of small, local entities.

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96 Prop. Reg. § 1.1471-5(f)(1)(i)(D)(5).

97 For example, in certain circumstances an agency or branch of a U.S. person located outside the United States will not be treated as a U.S. person under Regulation S.

98 This comment applies equally to the rule that excuses a restricted distributor from having to conduct a PFFI-type review of sales made after December 31, 2011 and prior to the time it entered into a qualifying distribution agreement of the type contemplated by the Proposed Regulations, in cases where there was a prohibition on the sale of fund interests to U.S. entities or U.S. resident individuals. *See* Prop. Reg. § 1.1471-5(f)(4)(viii).

Two categories of certified deemed-compliant FFIs represent smaller entities that either (i) are nonregistering local banks or (ii) only maintain accounts with a value of no more than $50,000. Nonregistering local banks and FFIs with only low-value accounts are not required to maintain policies and procedures to exclude account holders that are specified U.S. persons, passive NFFEs with substantial U.S. owners, or nonparticipating FFIs.

The nonregistering local bank category does not include bank-like FFIs that do not conform to the U.S. tax definition of a bank. In addition, Investment FFIs and insurance-type FFIs do not qualify as low-value account FFIs. Only depositary and custodial institutions qualify. We recommend that both of these categories of certified deemed-compliant FFIs be broadened and simplified in several respects.

First, any type of FFI (depositary institution, custodian, Investment FFI, or insurance company) should be entitled to qualify for one of these two categories. In this regard, the category of nonregistering local banks appears to reflect a policy decision that smaller, local FFIs engaging primarily in a regulated activity of making loans and taking deposits from retail customers present a relatively low risk of serving as vehicles for tax evasion by U.S. persons. In addition, smaller institutions are likely to bear a disproportionate burden in complying with the requirements for PFFIs or deemed-compliant FFIs. If these are indeed the rationales for exempting nonregistering local banks, then other small institutions such as non-bank finance companies, postal and other savings institutions and life insurance companies should be included as well. We therefore recommend that final regulations contain a broader set of exemptions of small, local entities.

In a similar vein, the category of FFIs with only low-value accounts appears to reflect a policy decision that such entities present a low risk of serving as the medium for tax evasion by U.S. persons and that the benefits of requiring such entities to become either PFFIs or registered deemed-compliant FFIs would not justify the costs (assuming that such entities would not simply disinvest from the United States or be forced to close). We do not see why a similar policy rationale should not apply to Investment FFIs and insurance-type FFIs that maintain only small accounts. There is little practical or economic difference, for example, between an investment advisor that applies a similar investment strategy to a group of managed accounts (which could qualify as a certified deemed-compliant FFI under the Proposed Regulations), and a collective investment vehicle (which could not so qualify).[99] Likewise, it is not clear to us why insurance-

[99] Indeed, depending on the facts, formally separate custodial accounts could be treated for U.S. tax purposes as such a collective investment vehicle. *Compare Comm'r v. N.B. Whitcomb Coca-Cola Syndicate*, 95 F.2d 596 (5th Cir. 1938) (arrangement under which subscribers funded a manager to purchase and sell stock of a specific company for their joint account treated as a partnership for tax purposes) *with Estate of Smith v. Comm'r*, 313 F.2d 724 (8th Cir. 1963) (arrangement under which funds were deposited with a manager that shared in trading profits did not create a deemed partnership; rather, manager's share of profits treated as compensation for services). The uncertainty of whether a deemed entity results from certain common investment management arrangements creates a risk for FFIs seeking to rely on the low-value account exemption and their withholding agents.

type FFIs should not benefit from the relief for small FFIs with only low-value accounts. It is doubtful that insurance companies with no more than $50 million in assets would have the resources to become PFFIs or registered deemed-compliant FFIs.[100]

We also recommend that the definition of nonregistering local banks not refer to Section 581, because it necessarily requires interpretation by a U.S. tax specialist. Instead, we recommend that final regulations provide a functional definition of a bank, to the extent it is not incorporated in the requirement that the FFI be engaged primarily in the business of making loans and taking deposits from unrelated retail customers.

As discussed in Part III.C.5.a above, a second proposal to simplify the definition of nonregistering local bank is to exclude from final regulations any language indicating that the offering or advertisement of U.S. dollar denominated deposits or other investments constitutes the solicitation of account holders outside the FFI's country of incorporation or organization.

Third, to facilitate compliance, we recommend that the balance sheet tests for a nonregistering local bank should be applied annually, based on the currency exchange rate in effect at the close of the FFI's financial year. We also recommend that the $50,000 low-value account tests be applied annually at the close of the FFI's financial year, based on the currency exchange rate in effect on that date.

Fourth, we recommend that final regulations eliminate the requirement for a review of financial statements by a withholding agent. Alternatively, a withholding agent should be permitted to rely on a written statement of an internal or external accountant or attorney that such person has made appropriate due diligence and inquiry to the best of that person's knowledge, the FFI satisfies each of the requirements to be classified as a nonregistering local bank or as an FFI with only low-value accounts.

7. Final regulations should simplify and clarify in a number of respects the treatment of Broad-Based Retirement Funds.

The Proposed Regulations provide for two types of retirement funds that are exempt beneficial owners: (1) retirement funds that qualify for treaty benefits;[101] and (2) certain Broad-Based Retirement Funds.[102] Two other types of retirement funds are treated as certified deemed-

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[100] We understand that life insurance companies typically derive little if any profit from the receipt of premiums, and that the investment of those premiums generates the cash needed to pay expenses and benefits to policy holders. An insurance company with $50 million in assets that derives a 5% return on those assets will have income of $2.5 million. We believe the cost of becoming a PFFI for these companies could be substantial in relation to their profits.

[101] Prop. Reg. § 1.1471-6(f)(1)(i).

[102] Prop. Reg. § 1.1471-6(f)(1)(ii). The Proposed Regulations indicate that a Broad-Based Retirement Fund that allows employees to make contributions based on a percentage of their compensation income is an "investment

compliant FFIs: (3) Broad-Based Retirement Funds that would be exempt beneficial owners, but for the fact that (a) they are investment conduits and/or (b) local laws provide favorable tax treatment at the level of the employees/beneficiaries of the fund, instead of at the level of the retirement fund itself (as required for exempt beneficial owner status);[103] and (4) certain Narrow-Based Retirement Funds.[104]

The categories of retirement funds described above should be clarified and rationalized, particularly in the case of Broad-Based Retirement Funds. First, it is not clear to us that it is necessary to have two separate categories of Broad-Based Retirement Funds that are given a favorable status for purposes of chapter 4. As a practical matter, if a Broad-Based Retirement Fund is recognized as a retirement or pension vehicle under local law, receives all contributions (other than rollovers from other retirement accounts) from the government, employer or employees in amounts limited by reference to earned income, and provides favorable economic treatment (i.e., foreign tax benefits for the employee or the fund, or material contributions from the government or an employer to the fund), then it is unlikely the fund is being used for income tax evasion by U.S. persons. This is true regardless of whether the fund itself, or its beneficiaries, are treated as the owners of the fund's assets under U.S. tax principles (i.e., regardless of whether the fund is an investment conduit or not). If the requirements just enumerated are met, then the fund should be recognized as a person exempt from Section 1471 withholding; and it should not be necessary to look to two different regimes (the exempt beneficial owner regime and deemed-compliant FFI regime), each with its own distinct certification and other procedural requirements, in order to accomplish this result. We recommend that final regulations choose one of those two regimes to cover all Broad-Based Retirement Funds.

Second, the Proposed Regulations generally do not treat grantor trusts as "payees" or "account holders". Rather, the relevant payees or account holders are the owners of the grantor trust.[105] Accordingly, a retirement fund that is treated as a grantor trust in respect of a beneficiary's contributions would appear not to be able to claim exemption from Section 1471 withholding on its own behalf; and a withholding agent or PFFI that makes payments to such a retirement fund would not be able to avoid reporting in respect of the beneficiary. We

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conduit," and will not qualify as an exempt beneficial owner. Prop. Reg. § 1.1471-6(f)(2), Example 3. Instead, it appears such a retirement fund will likely be classified as grantor trust for U.S. federal income tax purposes with respect to one or more of its beneficiaries. *See* I.R.C. § 402; Treas. Reg. § 1.402(b)-1(b)(6). This type of grantor trust will qualify as a certified deemed-compliant FFI, if it meets certain requirements that are very similar to the requirements that a Broad-Based Retirement Fund must meet to qualify as an exempt beneficial owner. *See* Prop. Reg. § 1.1471-5(f)(2)(ii)(A)(1).

103 Prop. Reg. § 1.1471-5(f)(2)(ii)(A)(1); *see* Prop. Reg. § 1.1471-6(f)(1)(ii)(D).

104 Prop. Reg. § 1.1471-5(f)(2)(ii)(A)(2).

105 *See* Prop. Reg. §§ 1.1471-3(a)(2) and 1.1471-5(a)(3)(ii).

recommend that the final regulations clarify that a Broad-Based Retirement Fund that is a grantor trust and that possesses the characteristics described above should be treated as a payee, and as an accountholder, with respect to amounts paid to it and with respect to financial accounts that it holds with withholding agents or other FFIs.

Third, under the Proposed Regulations, one of the requirements for a Broad-Based Retirement Fund to qualify as a certified deemed-compliant FFI is that either employees not be subject to tax on investment income earned by the fund or employees be entitled to deduct contributions to the fund from earned income. Assuming this requirement is retained in the final regulations, it should only require an examination of the tax rules that apply generally to beneficiaries who are resident in countries where a majority of the retirement fund beneficiaries were employed when they made contributions, or when contributions were made on their behalf.[106]

We believe that limiting the examination of local law in this manner will avoid the risk that retirement funds that are part of a multinational plan fail to qualify due to the local tax treatment of a minority of the beneficiaries, or because retired employees cease to be subject to deferred tax on the fund's investment income by the country where such individuals were employed when they move to another country. We also do not believe that these modifications will substantially increase the risk of retirement plans serving as potential vehicles for U.S. tax evasion.

8. Final regulations should increase the number of allowable participants in a Narrow-Based Retirement Fund and relax the limits on the number of those participants that may be non-residents of the country where the fund is organized. Final regulations should also allow the employees of an Investment FFI to be covered by a Narrow-Based Retirement Fund.

We believe that the definition of a Narrow-Based Retirement Fund under the Proposed Regulations is sufficiently circumscribed that many smaller funds that cannot meet the requirements for Broad-Based Retirement Funds will be unable to obtain deemed-compliant status. For example, if a retirement fund has 20 beneficiaries, it cannot qualify as a Narrow-Based Retirement Fund.[107] It also cannot qualify as a Broad-Based Retirement Fund, which excludes any fund in which any single beneficiary has a right to more than 5% of the fund's assets, unless each of the 20 beneficiaries has an equal interest in the retirement fund. This is unlikely to be the case if, for example, the beneficiaries started their participation in the

[106] We recommend that the requirement for deferral of tax on a retirement fund's investment income be broadened so that it is satisfied if such income is exempt from local tax. The reason for this suggestion is that many countries provide for complete or partial exemptions of distributions from certain retirement funds. For example, the United States generally exempts distributions by a Roth 401(k) plan.

[107] Prop. Reg. § 1.1471-5(f)(2)(ii)(A)(2).

retirement fund at different times, or have different compensation levels that affect the size of their economic interest the retirement fund. To allow more small retirement funds to qualify for deemed-compliant status, we recommend that the definition of a Narrow-Based Retirement Fund be revised to permit up to, say, 200 participants.

In addition, the requirements that a Narrow-Based Retirement Fund not have more than 20% of its assets attributable to non-residents of the country where the FFI is organized, and that no non-resident participant be entitled to more than $250,000 of the FFI's assets,[108] creates a risk that the retirement fund's status will be lost merely because retirees move from one country to another for work-related reasons. For the reasons discussed above, we do not believe that is an appropriate result. We therefore recommend that these requirements apply only to participants who are currently employed by the sponsoring employer or a member of its expanded affiliated group. We also recommend that these requirements exclude current employees who relocate to another country and, following such relocation, are employed by the sponsoring employer or a member of its expanded affiliated group in that country.

Finally, we are not clear what policy rationale is served by the requirement that a Narrow-Based Retirement Fund not be sponsored by an employer that is an Investment FFI.[109] Possibly this is motivated by a concern that hedge funds may establish retirement funds for their managers, and that such retirement funds may be more prone to being used to hide assets overseas. It is not clear to us that hedge fund managers are more apt to hide assets abroad than other taxpayers. Even if that were the case, in our experience retirement funds for hedge fund managers are established by the investment manager (which may not be an FFI if it serves only a managerial role), and not the hedge fund itself. We therefore recommend that this requirement be eliminated, or if this recommendation is not adopted, that the requirement exclude employers that are themselves exempt beneficial owners, deemed-compliant FFIs or PFFIs.

Comments on Exempt Beneficial Owners (Recommendation 9)

9. We recommend that final regulations create a new category of exempt beneficial owner: a treaty-qualified non-profit organization.

For much the same reasons as it is appropriate for a treaty-qualified retirement fund to be an exempt beneficial owner, we believe it also is appropriate to extend such treatment to a treaty-qualified non-profit organization. Specifically, the exemption would apply to a non-profit organization that (i) is established in a treaty jurisdiction; (ii) is established and maintained in its country of residence exclusively for religious, charitable, scientific, artistic, cultural or educational purposes; (iii) is generally exempt from income taxation in that country; and (iv) is entitled to benefits under the treaty on income derived from U.S. sources as a resident of the

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108 *Id.*

109 *Id.*

other country that satisfies any applicable limitation on benefits requirement. We recommend that a withholding agent be entitled to rely on a withholding certificate provided by an exempt beneficial owner that is a treaty-qualified non-profit organization, if the certificate claims benefits as a resident of a treaty country that is entitled to benefits under the relevant tax treaty.

The addition of this new category of exempt beneficial owner should allow these organizations a less burdensome means of complying with FATCA than the alternatives available under the Proposed Regulations: to be a certified deemed-compliant FFI or excepted FFI that provides a letter of counsel or other documentary evidence to the withholding agent.

IV. Qualifying as a PFFI: Obligations under an FFI Agreement

A. Background

An FFI that is not a deemed-compliant FFI or exempt beneficial owner must become a PFFI and enter into an FFI agreement in order to avoid becoming subject to Section 1471 withholding on withholdable payments and passthru payments it receives. Under its FFI agreement, a PFFI generally will be required to identify and document its U.S. accounts, comply with verification and due diligence procedures, undertake account reporting, attempt to obtain waivers of foreign laws that preclude reporting, and undertake FATCA withholding on passthru payments to recalcitrant account holders and nonparticipating FFIs. A material failure by the PFFI to comply with the terms of its FFI agreement may constitute an event of default that terminates the FFI agreement and causes the FFI to become a nonparticipating FFI that is subject to FATCA withholding.

1. Diligence and Documentation Procedures for Identification of Account Holders and Information Reporting Requirements

The Proposed Regulations describe the account identification, documentation and diligence procedures that PFFIs will be required to follow under their FFI agreements to identify U.S. accounts, accounts held by recalcitrant holders and accounts held by nonparticipating FFIs.[110] Absent a contrary undertaking in the FFI agreement, complying with these procedures will conclusively satisfy a PFFI's obligation to identify account holders and document their accounts. Unless the required documentation is obtained within specified time periods, the account holder will be presumed to be a nonparticipating FFI in the case of an entity and a recalcitrant account holder in the case of an individual.[111]

Pursuant to its FFI agreement, a PFFI will be required to report information about U.S. accounts and recalcitrant account holders to the IRS on an annual basis, beginning in 2014 with

110 Prop. Reg. § 1.1471-4(c).

111 *See* Prop. Reg. §§ 1.1471-3(f)(4) and 1.1471-5(g)(2)(i).

reporting with respect to the 2013 calendar year.[112] The Proposed Regulations outline the general reporting requirements that will apply, including how the reporting obligations will be phased-in. In addition to the annual reporting requirements in its capacity as a PFFI, a PFFI that acts as a withholding agent with respect to any withholdable payment or foreign passthru payment will be subject to the general reporting requirements applicable to withholding agents under FATCA with respect to such payments and to certain additional reporting obligations during the period before withholding on foreign passthru payments begins.

The information on U.S. accounts that a PFFI generally must report includes account holder identification information, account values, and payments made with respect to the account. A PFFI will be required to report the aggregate number, and aggregate value, of accounts held by recalcitrant account holders. The report will specify the portion of these accounts attributable to recalcitrant account holders that have U.S. indicia. In its capacity as a withholding agent, a PFFI will be required to file Forms 1042 and 1042-S with respect to withholdable payments, as well as with respect to payments of "foreign reportable amounts" that it makes in 2015 and 2016 and foreign passthru payments that it makes thereafter.

2. Definition of Financial Accounts and U.S. Accounts

For purposes of the above reporting rules, the Proposed Regulations define a financial account as: (i) a depositary account;[113] (ii) a custodial account;[114] (iii) a debt or equity interest in an Investment FFI that is not regularly traded on an established securities market; (iv) a debt or equity interest issued by any other type of FFI that is not regularly traded and has a value determined directly or indirectly primarily by reference to assets that give rise to withholdable payments;[115] and (v) cash value and annuity contracts maintained by a financial institution.[116]

In general, a "U.S. account" is a financial account held by one or more "specified U.S. persons" or a "United States owned" non-U.S. entity. Specified U.S. persons are U.S. persons other than: a corporation the stock of which is regularly traded on an established securities market, certain corporate affiliates of such regularly traded corporations; tax-exempt and

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[112] Prop. Reg. § 1.1471-4(d).

[113] A "depositary account" is defined to include a number of typical deposit accounts as well as any amount held by an insurance company under an agreement to pay or credit interest on the amount. Prop. Reg. § 1.1471-5(b)(3)(i).

[114] A "custodial account" is defined as an account maintained for the benefit of another person that holds any financial instrument or contract held for investment, including currency or commodity transactions, derivative contracts and insurance or annuity contracts. Prop. Reg. § 1.1471-5(b)(3)(ii).

[115] Prop. Reg. § 1.1471-5(b)(3)(iii).

[116] I.R.C. § 1471(d)(2).

governmental organizations and certain other U.S. persons that are considered to represent a low risk of failure to report their non-U.S. holdings to the U.S. government. A U.S. owned foreign entity is defined as a non-U.S. entity (including one formed in a possession of the United States) with one or more "substantial U.S. owners." In general, substantial U.S. owners are specified U.S. persons with a 10% ownership stake in a non-U.S. entity. However, when applied in the case of Investment FFIs or (in certain cases) insurance companies, any ownership by a specified U.S. person is considered substantial regardless of how small the stake is.

3. Withholding Requirements

Subject to certain exceptions, a PFFI will be required to withhold 30% of any "passthru payment" made to a recalcitrant account holder or nonparticipating FFI.[117] Effectively, a PFFI must withhold on most U.S. source FDAP income and, following a phase-in period, gross proceeds from the disposition of debt and equity of U.S. issuers and other payments that are "attributable" to such FDAP income and gross proceeds.[118] Withholding with respect to such passthru payments will be phased in after 2013 as discussed below. Withholding will not be required to the extent an agreement between the IRS and a foreign government provides otherwise.

When making a withholdable payment or foreign passthru payment, to ascertain whether the payment may be subject to withholding, a PFFI must determine whether (i) the account holder is, or must be presumed to be, a recalcitrant account holder[119] or (ii) it is paying, or must be presumed to be paying, a nonparticipating FFI.[120]

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117 Prop. Reg. § 1.1471-4(b). Passthru withholding by a PFFI should not apply to payments under its "grandfathered obligations" that are outstanding on January 1, 2013 and held by a recalcitrant account holder, PFFI or nonparticipating FFI.

118 A "passthru payment" is defined as any withholdable payment and any foreign passthru payment. A "withholdable payment" generally means any payment of, and after 2014, gross proceeds from the disposition of a debt or equity instrument that produces, U.S. source FDAP. A "foreign passthru payment" is any other payment to the extent attributable to a withholdable payment; the Proposed Regulations reserve on providing a more specific definition.

119 Subject to certain exceptions, an account holder is a "recalcitrant account holder" if the holder fails to provide requested information or documentation.

120 We note that, although the Proposed Regulations could be clearer in this regard, in the case of an FFI, it seems that withholding on passthru payments to FFIs may not depend on whether the FFI is an account holder but apparently does depend on whether it is a "payee." The rules of Proposed Regulations section 1.1471-4(b) can be read to trump the rules of Proposed Regulations section 1.1471-2 in the case of PFFIs. *See* Prop. Reg. §§ 1.1471-4-4(b)(2) and 1.1471-2(a)(3). Literally, Section 1471(b) describes passthru payments made to an FFI that is nonparticipating FFI, rather than to a "payee" that is a nonparticipating FFI. However, we believe the reference to payments incorporates the payee concept, and what is intended is to require withholding on passthru payments "to a payee that the PFFI must treat as a nonparticipating FFI."

The Proposed Regulations gradually phase-in withholding on passthru payments. Withholding on withholdable payments (i.e, passthru payments other than foreign passthru payments) will apply to payments of U.S. source FDAP beginning January 1, 2014 and other withholdable payments (i.e, disposition proceeds) beginning January 1, 2015. Withholding on foreign passthru payments will not begin before January 1, 2017, although transitional reporting of payments of certain FDAP income paid to FFIs that are nonparticipating FFIs will be required after 2014, as discussed below.

4. Expanded Affiliated Group Rules

An FFI that is a member of an expanded affiliated group will not be permitted to become a PFFI unless every other FFI in its group is either a PFFI or a registered deemed-compliant FFI and, in addition, a PFFI or registered deemed-compliant FFI must agree to all of the requirements for that status with respect to all of its branches, offices and divisions (the "all or nothing rule").[121] The Proposed Regulations relax the all or nothing rule during transition, so that in certain circumstances an FFI may become a PFFI even if this all or nothing rule is not met during the period until January 1, 2016.[122] However, as of January 1, 2016, if all FFI members of an expanded affiliated group are not in compliance, an FFI will cease to be a PFFI.

5. Waivers

Under the Proposed Regulations, the FFI agreement which a PFFI enters into must provide that, if a foreign law would (but for a waiver) prevent the FFI from reporting under FATCA with respect to a U.S. account, then the FFI will obtain a valid, effective waiver of such law by the accountholder, and if such a waiver is not obtained within a reasonable period of time, the FFI will close the account.[123]

6. Verification

The Proposed Regulations set forth verification procedures that a PFFI will be required to follow, such as: (i) adopting written policies and procedures governing due diligence to identify and document accounts, withholding and reporting; (ii) conducting periodic reviews; and (iii) certifying compliance.[124] The FFI may be required to provide information or disclose

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Beginning in 2014, in addition to withholding on passthru payments to a nonparticipating FFI, a PFFI also must withhold on withholdable payments made to a PFFI that has made an election under Section 1471(b)(3) not to comply with the withholding obligations imposed on PFFIs.

121 Prop. Reg. § 1.1471-4(e).

122 Generally, this transition rule applies to affiliated FFIs or branches that are subject to laws prohibiting compliance with FATCA and that agree to comply with certain due diligence and other requirements.

123 Prop. Reg. § 1.1471-4(a)(5).

124 Prop. Reg. § 1.1471-4(a)(6).

material failures by the FFI to comply. If requested, the FFI must provide additional information to the IRS. The IRS may verify compliance using approved external auditors if it identifies concerns based on the information provided in periodic certifications, including a suspected pattern of compliance failures.

7. Termination

The Proposed Regulations provide that an FFI agreement will specify the compliance failures and other conditions under which a PFFI would be in default of the FFI agreement.[125] The agreement will provide that a compliance failure will not constitute an event of default unless such failure occurs in more than limited circumstances when a PFFI has not substantially complied with its obligations under the FFI agreement.

B. Summary of Recommendations

1. Final regulations should clarify the expected role of an FFI agreement within the FATCA regime and should provide standards for departing from standard requirements to address the case of a particular FFI.

2. Final regulations should clarify the relationship between the procedures in Proposed Regulations section 1.1471-3 and those in section 1.1471-4 dealing with a PFFI's due diligence on its accounts.

3. Final regulations should clarify when a debt or equity interest issued by an FFI that tracks an asset giving rise to withholdable payments is considered to be a financial account.

4. Treasury and the IRS should give additional consideration to whether derivative contracts are financial accounts.

5. The definition of a "depositary account" should be clarified in final regulations, including, inter alia, how to distinguish a depositary account from a debt obligation of an FFI.

6. Final regulations should broaden the types of low-value accounts excluded from the definition of "U.S. account." In addition, consideration should be given to increasing the ceiling for a low-value account, in the case of an account held by a resident of the country where the FFI issuing the account is located.

7. Pending final regulations on the definition of foreign passthru payments, Treasury should consider providing interim guidance clarifying that foreign passthru payments will be limited to payments on financial accounts.

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125 Prop. Reg. § 1.1471-4(a)(7).

8. Final regulations should require PFFIs to withhold on foreign passthru payments to any U.S. person that cannot certify that it is not acting as an intermediary for (or otherwise passing on the economic benefit of the payments to) a nonparticipating FFI.

9. Final regulations should clarify that a PFFI must have custody, control, receipt or disposal of passthru payments in order for withholding to apply.

10. The transitional Form 1042-S reporting requirement in Proposed Regulations section 1.1474-1(d)(2)(ii) should be defined to include payments that are contingent upon, or determined by reference to, payments of U.S. source FDAP income (or comparably limited).

11. The definition of "expanded affiliated group" should be revised to address attempts at "de-grouping" as well as certain other cases.

12. An expanded affiliated group should be allowed to continue to own a historic limited FFI affiliate or limited branch, provided that the group implements appropriate safeguards, and to maintain accounts for local-country banks or insurance companies that are nonparticipating FFIs, at least on a transitional basis.

13. The all or nothing rule governing a PFFI in an expanded affiliated group should be made less restrictive, by permitting a group to include certain entities other than PFFIs and registered deemed-compliant FFIs (e.g., exempt beneficial owners).

14. Coordinating a QI external audit with PFFI compliance verification should be optional for a PFFI.

15. Final regulations should clarify what constitutes an event of default, the obligations of a "responsible officer" to report events of default to the IRS, and the consequences of an event of default.

C. <u>Discussion</u>

General Comments (Recommendations 1 and 2)

We applaud the efforts of Treasury and IRS have made in Proposed Regulations section 1.1471-4 to make complying with the PFFI regime more administrable and less burdensome. As a general matter, we believe that the Proposed Regulations strike an appropriate balance (within the constraints of the statute) between the information reporting goals of FATCA and the associated compliance burdens they will impose on financial institutions. We believe that striking this balance will be critical to the ultimate success of this regime because the model FFI agreement effectively will establish a reporting regime for a very large number of diverse foreign institutions. Complying with the regime will require most FFIs to fundamentally redesign their back-office systems and account opening and maintenance procedures and to comply with novel reporting obligations. Not all of these FFIs will be large institutions with unlimited budgets for sophisticated U.S. tax advisors conversant with every nuance of FATCA withholding and compliance. Consequently, the clarity, simplicity and administrability of these rules, always an important tax policy objective, is particularly critical in this case. A recurring theme in our comments on the FFI agreement provisions of the Proposed Regulations is that the rules should not sacrifice clarity and administrability in an effort to eliminate every theoretical opportunity for avoidance.

1. Final regulations should clarify the expected role of the FFI agreement within the FATCA regime and should provide standards for departing from standard requirements to address the case of a particular FFI.

One general concern we have with the Proposed Regulations is that they provide detailed rules and procedures for an FFI agreement without first clarifying its general role and function within the statutory scheme of chapter 4.

On the one hand, an FFI agreement can be understood as a device by which the United States may impose "voluntary" reporting obligations on foreign institutions otherwise beyond its regulatory jurisdiction by imposing withholding on those institutions that elect not to participate. On the other hand, the contractual nature of an FFI agreement affords more flexibility to negotiate terms peculiar to a particular institution or category of institution than a purely rule-based reporting regime would allow. A number of provisions in Proposed Regulations section 1.1471-4, for example, impose obligations "except to the extent the FFI agreement otherwise provides." It is unclear on what basis such departures from the normal rules will occur and what rules would apply in their place.

We recommend that the Treasury and IRS clarify how FFI agreements are intended to function, recognizing that this may become clearer when the draft model FFI agreement is released. It may well make sense to customize FFI agreements to reflect institutional peculiarities of particular categories of PFFIs. As discussed below, for example, unless major clearing systems are able to operate under a workable regime, other institutions that must interact with these entities in the capital markets may find it impossible to comply with their own obligations under chapter 4. On the other hand, we do not believe Congress envisioned the FFI agreement as an individually tailored reporting regime for particular PFFIs peculiar to their factual circumstances, like the arrangements that exist in other contexts such as Advance Pricing Agreements. Given the numbers of institutions that will be affected by FATCA, this would not be practicable. Without clear standards for relief, however, the potential exists for a system to emerge that offers individually negotiated arrangements for very large institutions (particularly if governments seek to exert political pressure on behalf of their more important local institutions) but only boilerplate FFI agreements for the rest. Although this may be justified from the perspective of regulatory resource allocation, it may raise significant due process concerns.[126]

We recommend that Treasury and the IRS, perhaps in a preamble to final regulations or a Revenue Procedures, provide general guidance regarding the standards and procedures pursuant to which departures from the default provisions in Proposed Regulations section 1.1471-4 will be considered.

2. Final regulations should clarify the relationship between the procedures in Proposed Regulations section 1.1471-3 and those in section 1.1471-4 dealing with a PFFI's due diligence on its accounts.

Proposed Regulations sections 1471-4(b) and (c) superimpose certain specific requirements for PFFIs on the basic withholding and payee identification and documentation rules for withholding agents under Proposed Regulations section 1.1471-3. We believe this approach creates some risk of confusion.

As one example, Proposed Regulations section 1.1471-4(c)(2)(ii) provides that "except as otherwise provided in paragraph (c)(4)," the standards of knowledge in section 1.1471-3(e) apply. Yet, it also restates the general "knows or has reason to know" standard of knowledge, begging the question whether this differs from the -3(e) standards. Nor is it self-evident which, if any, of the many requirements and procedures in Proposed Regulations section 1.1471-4(c) in fact conflict with Proposed Regulations section 1.1471-3(e).

As another example, Proposed Regulations section 1.1471-4(c) states that the general principles of Proposed Regulations section 1.1471-3 are to be applied as if the PFFI were a withholding agent making a payment and the account holder were a "payee." We anticipate that many less sophisticated foreign institutions will be confused by this language, interpreting it to mean that they should apply the specific rules as to when one must "look through" intermediaries or flow-through entities for purposes of the "payee" definition to determine who the "account holder" is under Proposed Regulations section 1.1471-4. We believe that what in fact is intended is that once the account holder has been identified using the conventions in the definition of that term in the Proposed Regulations, a PFFI then should apply all the rules in Proposed Regulations section 1.1471-3(b)-(f) (including documentation requirements, presumptions to be applied in the absence of complete documentation, and standards of knowledge) to the account holder, in the same manner as if that account holder were a "payee" under Proposed Regulations section 1.1471-3(a) (regardless of whether the account holder in fact would be the payee if the PFFI

126 We believe that a potential significant advantage of negotiating FATCA implementation agreements with partner countries is that in the context of an implementation agreement, Treasury and a partner country's government can devise tailored arrangements that fit the specific situation of different categories of FFIs in a partner country. Dealing with all FFIs in a particular country on a comprehensive and transparent basis in such an agreement will limit the ability of individual institutions to secure more favorable terms.

were to make a withholdable payment to such person). However, the drafting is not entirely clear on this point.[127]

Given the purpose of the FFI agreement to explain how a broad and diverse range of non-U.S. institutions should implement appropriate back office systems and procedures for opening and maintaining accounts, we recommend that the model FFI agreement set forth the applicable requirements in full rather than by cross-reference to the general withholding agent procedures. Alternatively, it would be helpful for final regulations and the model FFI agreement to more clearly highlight the specific provisions in Proposed Regulations section 1.1471-4(c) that are intended to override the general -3 principles.

Comments on the Definition of Financial Accounts (Recommendations 3-6)

3. Final regulations should clarify when a debt or equity interest issued by an FFI that tracks an asset giving rise to withholdable payments is considered to be a financial account.

Debt and equity of any financial institution that is regularly traded on an established securities market is excluded from the definition of financial account.[128] The definition also excludes debt and equity of an FFI that is a depositary bank, custodian or insurance company, so long as the value of the debt or equity interest is not "determined, directly or indirectly, primarily by reference to assets that give rise to withholdable payments."[129] While we agree with the principle that an instrument that provides for payments that track withholdable payments should be treated differently, we think that the phrasing in the Proposed Regulations is open to misinterpretation. Rather than focusing on whether the value of an instrument is affected by assets that give rise to withholdable payments, the rule should focus on whether the actual

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[127] The differences between the definition of payee and the definition of account holder can potentially lead to unusual results. In particular, if a U.S. withholding agent makes a payment of U.S. source FDAP to a PFFI that is acting as an intermediary and is not a QI, then the PFFI is not the payee; instead, the beneficial owner of the payment is. Prop. Reg. § 1.1471-3(a)(3)(i)(A)(2). In addition, if a U.S. withholding agent pays U.S. source FDAP to a U.S. financial institution as intermediary for a foreign beneficial owner and has reason to know the U.S. financial institution will not comply with its obligations under FATCA, the U.S. withholding agent must treat the foreign beneficial owner as the payee. Prop. Reg. § 1.1471-3(a)(3)(iii). By comparison, it appears that if a PFFI makes a payment of U.S. source FDAP to an account holder that is a financial institution (U.S. or foreign), then the PFFI must decide whether to withhold on the payment under Treasury Regulations section 1.1471-4(b)(1) by reference to the chapter 4 status of the financial institution, regardless of whether it is acting as an intermediary. *See* Prop. Reg. §§ 1.1471-4(b)(1), (c), 1.1471-5(a)(3)(iii). It is not clear whether this result is intended.

[128] I.R.C. § 1471(d)(2).

[129] Prop. Reg. § 1.1471-5(b)(1)(iii).

payments on the debt or equity are contingent on, or calculated by reference to, payments on assets that give rise to withholdable payments.[130]

4. Treasury and the IRS should give additional consideration to whether derivative contracts are financial accounts.

A "custodial account" is defined as an account maintained for the benefit of another person that holds any financial instrument or contract held for investment, including currency or commodity transactions, derivative contracts and insurance or annuity contracts.[131] Although a custodial account may be a financial account because it contains one or more derivative contracts, a bilateral derivative contract itself is not a financial account. If, for example, a PFFI enters into a swap with a nonparticipating FFI, the swap would not itself be a financial account. It is our understanding that many such contracts are not held in custodial accounts and would therefore not involve payments being made on or through a financial account.

If passthru withholding is imposed on all payments made to a nonparticipating FFI by a PFFI, this may be a distinction without a difference. As discussed in recommendation 7 below, however, we believe the passthru withholding regime will function more effectively if it is limited to payments made on financial accounts. If this approach is adopted by Treasury and the IRS, then consideration should be given to whether the definition of financial account should be expanded to include the types of derivative contracts described in the preceding paragraph.[132]

5. The definition of a "depositary account" should be clarified in final regulations, including, inter alia, how to distinguish a depositary account from a debt obligation of an FFI.

A depositary account is defined as a commercial, checking, savings, time, or thrift account, or an account which is evidenced by a certificate of deposit, thrift certificate, investment certificate, certificate of indebtedness, *or other similar instrument* as well as any amount held by an insurance company under an agreement to pay or credit interest thereon.[133] The scope of the term "or other similar instrument" is not entirely clear. For example, if the term is intended to capture only instruments similar to "certificates of indebtedness", then any evidence of

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130 *Cf.* I.R.C. § 871(m). We believe that similar logic should underlie the definition of "other reportable amounts" in the transitional reporting requirements that apply to PFFIs prior to the effectiveness of the final foreign passthru payment regime. This point is discussed in Part IV.C.10 below.

131 Prop. Reg. § 1.1471-5(b)(3)(ii).

132 In a prior report, we have discussed considerations relating to treatment of derivatives as financial accounts. New York State Bar Association Tax Section, *Report on IRS Notice 2011-34 and IRS Notice 2011-53*, at 6-7, 11 (Rep. No. 1253, Jan. 12, 2012).

133 Prop. Reg. § 1.1471-5(b)(3)(i).

indebtedness could conceivably be viewed as a similar instrument. This reading, however, would substantially diminish the significance of the third prong of the definition of "financial account," which draws a clear distinction between different types of debt instruments issued by different types of FFIs and treats only certain types of debt instruments as financial accounts.

On balance, we believe that "similar instrument" is an instrument that a financial institution stands ready to issue on set terms that are not subject to negotiation with a particular counterparty and that serves as a mere repository for cash. We suggest that Treasury and the IRS clarify this point in final regulations.

6. Final regulations should broaden the types of low-value accounts excluded from the definition of "U.S. account." In addition, consideration should be given to increasing the ceiling for a low-value account, in the case of an account held by a resident of the country where the FFI issuing the account is located.

Certain individual accounts are excluded from the definition of U.S. accounts.[134] In particular, a depositary account held solely by one or more individuals will not be classified as a U.S. account if the aggregate balance or value of the account, when aggregated with certain other accounts held by the individuals, does not exceed $50,000 at the end of a calendar year or the date on which the account is closed.[135] Although we approve of this rule, we recommend that it not be limited solely to depositary accounts. Given the low dollar threshold involved, we recommend that the same exclusion be applied to custodial accounts and insurance contracts that otherwise fall within the definition of a financial account. We recognize that the small depositary account exception is based on an express statutory exemption in Code section 1471(d)(1)(B). Nevertheless, we believe Treasury has broad authority, including under Code section 1474(f), to extend this exclusion to other types of accounts if it determines that expanding this exception is consistent with the purposes of FATCA and sensible from an administrative perspective.

In addition, we suggest that Treasury and the IRS consider increasing the threshold for an excluded account from $50,000 to, say, $200,000, in the case of an account held by an individual who is a resident of the country in which the FFI issuing or maintaining the account is located. We believe that an account held by a U.S. person who is a resident of the relevant country would seem to be prima facie more likely opened for reasons unrelated to tax avoidance, and to present fewer opportunities for abuse than an account owned by a non-resident. The regulations under Section 6038D recognize a generally similar distinction, providing a $200,000 threshold for

[134] Prop. Reg. § 1.1471-5(a)(4).

[135] *Id.*

reporting for accounts held by U.S. individuals resident in foreign countries, as compared to a general threshold of $50,000 for other U.S. individuals.[136]

Comments on Withholding Obligations (Recommendations 7-9)

7. Pending final regulations on the definition of foreign passthru payments, Treasury should consider providing interim guidance clarifying that foreign passthru payments will be limited to payments on financial accounts.

The Proposed Regulations reserve on the definition of foreign passthru payments. Previously, the Treasury had provided a definition of foreign passthru payments in Notice 2011-34. In an earlier report commenting on Notice 2011-34 and Notice 2011-53,[137] we recommended several changes to the proposed definition of foreign passthru payments. Because the Proposed Regulations now reserve on this definition, there is significant uncertainty as to what definition final regulations will adopt. Until then, taxpayers have no guidance other than the definition proposed under Notice 2011-34.

For the reasons discussed in our prior report, we believe the definition of foreign passthru payment in Notice 2011-34 is too broad, and in that report we proposed alternative approaches to addressing this issue. Whatever approach to foreign passthru payments is ultimately adopted, however, we recommend that until final regulations define the term, Treasury should provide interim guidance clarifying that payments that are not made on "financial accounts" will not be foreign passthru payments. Confining the definition of foreign passthru payments to payments on financial accounts through interim guidance should alleviate much of the current confusion in the financial markets on this issue.

Even though withholding on foreign passthru payments is postponed until 2017, current transactions in the financial markets must account for the potential impact of future withholding on the underlying payments. For example, there will be numerous debt and equity securities issued by FFIs before 2017. If the securities are publicly traded, or if they are issued by a commercial bank, the securities would generally not be treated as financial accounts. In addition, FFIs in the ordinary course of business would make various types of payments other than payments on financial accounts. Under the proposed definition in Notice 2011-34, a portion of any payment made by a PFFI, whether made on a financial account or not, would be considered a foreign passthru payment, subject to certain exceptions. In the absence of any guidance other than Notice 2011-34, FFIs and their counterparties are likely to devote significant time and resources to negotiating which party to a transaction will bear the burden of FATCA withholding

[136] Treas. Reg. §§ 1.6038D-2T(a)(1), (a)(4).

[137] New York State Bar Association Tax Section, *Report on IRS Notice 2011-34 and IRS Notice 2011-53*, (Rep. No. 1253, Jan. 12, 2012).

on numerous payments that could potentially be considered a foreign passthru payment. Unless it is clarified that foreign passthru payments only include payments in respect of financial accounts, FFIs will be forced to assume than any post-2016 payment will be subject to potential withholding as a foreign passthru payment.

We therefore recommend that the Treasury consider providing an interim definition of foreign passthru payment limited to payments on financial accounts.

8. Final regulations should require PFFIs to withhold on foreign passthru payments to any U.S. person that cannot certify that it is not acting as an intermediary for (or otherwise passing on the economic benefit of the payments to) a nonparticipating FFI.

Under the Proposed Regulations, although a PFFI must withhold on and report foreign passthru payments to a nonparticipating FFI, no corresponding obligations are imposed on U.S. financial institutions (or other U.S. withholding agents) with respect to foreign passthru payments. In the Preamble, comments are requested about ways to prevent a PFFI from using a U.S. financial institution (or other U.S. withholding agent) as a "blocker" to avoid FATCA withholding and reporting obligations for foreign passthru payments.[138]

In prior reports, we have recommended that guidance be issued to prevent U.S. financial institutions from being used in this manner.[139] In particular, this concern would arise where a U.S. financial institution, or other U.S. person, serves as a custodian or otherwise as an agent or intermediary with respect to a financial asset that gives rise to a foreign passthru payment. We suggest that when a U.S. withholding agent acts as an intermediary with respect to a foreign passthru payment on behalf of a nonparticipating FFI, the PFFI making the payment should be required to withhold. As a practical matter, this requirement could be administered by mandating that a PFFI making a foreign passthru payment to a U.S. person request a certification from the U.S. person that it is not receiving the payment as an intermediary for a nonparticipating FFI and withhold if the certification is not provided.

While we believe the above recommendation would largely remove the possibility for abuse, we note that it would not address some relatively limited opportunities for avoidance of the FATCA withholding and reporting obligations. In particular, if a U.S. person issues, say, a derivative that passes on the economics of an asset owned by the U.S. person that gives rise to foreign passthru payments, then a nonparticipating FFI might be able to receive payments on the

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138 *See* Preamble at section XIX.E, 77 Fed. Reg. at 9040.

139 *See* New York State Bar Association Tax Section, *Report on IRS Notice 2010-60*, at 29-30 (Rep. No. 1224, Nov. 16, 2010); New York State Bar Association Tax Section, *Report on IRS Notice 2011-34 and IRS Notice 2011-53*, at 11-12 (Rep. No. 1253, Jan. 12, 2012).

derivative that were treated as foreign source and, thus, would potentially be outside the scope of FATCA. In order to address such scenarios, Treasury and the IRS could consider adopting a rule that requires a PFFI to request a certification from a U.S. person to which foreign passthru payments are made that the U.S. person is not the party to any arrangement with a nonparticipating FFI under which the nonparticipating FFI will receive payments that are contingent on, or are determined by reference to, such foreign passthru payments; the PFFI would withhold if the certification is not provided.

We believe that in such cases, the most straightforward approach will be to place the withholding burden on the PFFI that is making a foreign passthru payment, rather than on the U.S. person receiving the payment. As a practical matter, we believe the PFFI may often have better information than the U.S. recipient about whether a payment is a foreign passthru payment, and the PFFI thus may be best placed to lead the process of gathering information in order to determine whether withholding is necessary. In addition, such withholding and related reporting responsibilities would be complementary to the obligations already imposed by FATCA on PFFIs regarding foreign passthru payments that they make directly to nonparticipating FFIs.

9. Final regulations should clarify that a PFFI must have custody, control, receipt or disposal of passthru payments in order for withholding to apply.

A PFFI may have chapter 4 withholding obligations in two capacities: (1) as a withholding agent under Sections 1471 and 1472 because it is a person with "control, custody, receipt, disposal or payment" of a withholdable payment and (2) directly as a PFFI under Section 1471(b) and under an FFI agreement. The Proposed Regulations generally resolve this potential overlap by providing that compliance with the FFI agreement satisfies a PFFI's withholding obligations as a withholding agent (although certain withholding agent reporting obligations may continue to apply). We support this and other efforts to rationalize the rules for PFFIs into a single coherent set of requirements within the applicable FFI agreement.

However, in resolving this overlap, the Proposed Regulations may inadvertently have read out the requirement that the PFFI have "control, custody, receipt, disposal or payment" of a withholdable payment. Proposed Regulations section 1.1471-4(b) contains no comparable construct and by its terms could be read to supplant the requirements under Proposed Regulations section 1.1471-2 in the case of PFFIs. Given the kinds of payments that will trigger a PFFI's withholding obligations, we do not foresee many situations where this would make a difference. We see no reason, however, why a PFFI should be treated less favorably than a regular withholding agent in this regard.

Comments on Reporting Obligations (Recommendation 10)

We support the changes made by the Proposed Regulations to rationalize the procedures for account reporting, including (i) characterizing payments based on local tax or customer reporting rather than federal income tax principles, (ii) allowing reporting based on local currency values, (iii) permitting chapter 61 information reporting by U.S. payors and branches to satisfy certain of their chapter 4 account reporting obligations and the election to report on the same basis as a U.S. payor with respect to U.S. individuals, and (iv) phasing in reporting obligations that will require more significant changes to the systems and procedures of financial institutions. However, the transitional payment reporting rules with respect to passthru payments merit some further consideration.

10. The transitional Form 1042-S reporting requirement in Proposed Regulations section 1.1474-1(d)(2)(ii) should be defined to include payments that are contingent upon, or determined by reference to, payments of U.S. source FDAP income (or comparably limited).

The Preamble expresses concern that the delayed effective date for withholding on foreign passthru payments creates "incentives for nonparticipating FFIs to use PFFIs to block the application of the chapter 4 rules" before withholding on foreign passthru payments begins. To address this concern, the Proposed Regulations require PFFIs to report in 2016 and 2017 on Form 1042-S any payments of foreign-source FDAP income and "other financial payments" made to nonparticipating FFIs during 2015 and 2016, respectively.[140] The Proposed Regulations however, reserve on the definition of, "other financial payments".[141]

In our view, the reporting required in 2016 and 2017 with respect to payments to nonparticipating FFIs made in 2015 and 2016 respectively is overbroad. The requirement to report foreign source FDAP income would require reporting of payments that are highly unlikely to constitute foreign passthru payments under any definition. For example, if a PFFI pays interest or dividends on a publicly traded equity or debt instrument to a nonparticipating FFI, the Proposed Regulations appear to require the PFFI to report these amounts even though such payments almost certainly will not be foreign passthru payments and do not seem to present the potential for abuse expressed in the Preamble.

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[140] Prop. Reg. § 1.1474-1(d)(2)(ii). The Proposed Regulations seem to contain a drafting error where they provide that "In the case of a PFFI that makes a payment to a nonparticipating FFI of a foreign reportable amount, the PFFI shall report with respect to each such nonparticipating FFI the aggregate amount of all such payments made to the <u>PFFI</u> for each of the calendar years 2015 and 2016." Presumably, the Proposed Regulations intended for the underscored language to read "nonparticipating FFI".

[141] Prop. Reg. § 1.1474-1(d)(2)(ii)(A)(2).

If the concern is the use of PFFIs by nonparticipating FFIs to cleanse the application of FATCA withholding on withholdable payments, this is fairly analogous to the abuse that Section 871(m) was designed to curtail. Section 871(m) imposes a 30% U.S. withholding tax on payments made under certain derivative instruments if the payments are "dividend equivalents" that are "contingent upon, or determined by reference to," U.S. source dividends, even if the payments would otherwise be treated as foreign source income. The effect of Section 871(m) is to prevent foreign persons from avoiding U.S. withholding tax on dividends by using derivatives to replicate direct ownership in assets that, if held directly, would produce dividends that are subject to withholding.

Because the purpose of Section 871(m) is analogous to the purpose of the transitional Form 1042-S reporting requirement, we recommend that final regulations require reporting on payments that are contingent upon, or determined by reference to, a payment of U.S. source FDAP income and not other types of foreign-source FDAP income. If considered necessary, this could be broadened, for example, to include payments determined by reference to changes in value of assets that produce U.S. source FDAP income or “similar” payments with respect to instruments or transactions structured with a principal purpose of avoiding reporting. However, we do not believe the theoretical possibility that the Treasury and IRS could decide to adopt a passthru payment definition of unlimited scope justifies imposing on financial institutions a costly transitional reporting regime for all payments of foreign source FDAP income and other financial payments.

Comments on the Expanded Affiliated Group Rules (Recommendations 11-13)

11. The definition of "expanded affiliated group" should be revised to address attempts at "de-grouping" as well as certain other cases.

The apparent purpose of the requirement that all members of an expanded affiliated group qualify as PFFIs is to prevent attempts by financial institutions to circumvent the reporting requirements by "migrating" their recalcitrant clients to a non-compliant FFI affiliate.

The definition of an "expanded affiliated group" is based on the definition of “affiliated group” under Section 1504, modified to adopt a lower 50% ownership threshold and to include foreign corporations and insurance companies. Section 1504 requires that both the vote and value satisfy the applicable threshold. We note that, in other contexts, taxpayers have found ways to "break" affiliation, for example by issuing voting preferred shares with voting power sufficient to deprive the real owner of the requisite voting power. We believe this is less likely here with a modified threshold of 50% as such techniques would deprive the FFI group of formal voting control of an entity, which is less commercially palatable than ceding only 21% of the vote. Nevertheless, 50% of the voting power is likely to convey effective control, especially if the remaining voting power is widely dispersed. Treasury and the IRS may wish to consider adopting an anti-abuse rule that disregards voting stock with limited participation in corporate growth, in a case where no owner of stock of such class owns over 10% of the total voting power of the corporation's stock and the arrangement has a principal purpose of "breaking" affiliation under chapter 4.[142] Such a rule would help to deter strategies to break affiliation by issuing a class of stock that lacks meaningful economic rights and also does not convey voting rights significant enough to convey a real voice in governance to the shareholder.

The definition of expanded affiliated group also includes partnerships and trusts if they are controlled, within the meaning of Section 954(d)(3), by other members of the expanded affiliated group (including other controlled partnerships or trusts), which generally would require ownership by a corporate affiliated group member of 50% or more of the beneficial interests. For the reasons described above, Treasury and IRS might consider excluding from the determination beneficial interests in such entities that provide limited participation in the growth of the entity's business if the arrangement has a principal purpose of "breaking" affiliation.

Conversely, Treasury and the IRS should consider adding a requirement that members of the group must have practical control over a partnership or trust (either 51% by voting power, or else control over the general partner, trustee or similar person with respect to the entity) in order for the partnership or trust to be a member of the expanded affiliated group. Without such control, FFIs in the group will not be able to compel the partnership or trust to become a PFFI or deemed-compliant FFI, leading to potentially harsh results under the all or nothing rule. We have elaborated on this observation in a prior report.[143]

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142 We note that the consequences of an anti-abuse rule applying in determining the members of an expanded affiliated group would be quite severe: all the PFFIs and registered deemed-compliant FFIs in the group would lose such status, potentially beginning in the first year in which actions were taken that violated the anti-abuse rule. In view of this, we suggest that any anti-abuse rule in the definition of expanded affiliated group meet two requirements: first, the rule itself should provide for a clear and focused set of factual criteria that must be satisfied in order for the rule to be invoked; and second, at least absent wilful misconduct, that PFFIs and registered deemed-compliant FFIs in the group lose such status only from the time a final determination is made that the anti-abuse rule applies.

In this regard, we note that Congress patterned the definition of expanded affiliated group after the definition of affiliated group in Section 1504(a)(2), a relatively bright-line rule, rather than choosing to base the definition on a more nuanced and complex precedent like Sections 1563 or 267(f). This suggests to us that, in interest of administrability, Congress wished to have a fairly clear definition of the relevant corporate group. We believe that the type of anti-abuse rule and other modifications suggested in the text are consistent with that intent.

143 New York State Bar Association Tax Section, *Report on IRS Notice 2011-34 and IRS Notice 2011-53,* (Rep. No. 1253, Jan. 12, 2012).

In a related point, we note that the ownership test in Section 1471(e)(2) and the Proposed Regulations for determining whether a partnership is a member of an expanded affiliated group is incorporated by reference from Section 954(d)(3), which in turn by its terms incorporates the constructive ownership rules of Section 958. As noted above, we believe Congress intended to focus on a relatively straightforward, administrable definition of expanded affiliated group in Section 1471(e)(2). Constructive ownership rules are absent from Section 1504(a), although they

In addition, we note that a group of commonly controlled entities can avoid treatment as an expanded affiliated group if they have no corporate common parent. We recognize that the publicly traded partnership rules under Section 7704 would preclude the use of such structures by publicly traded entities and the "check the box" rules limit the use of elections to achieve pass-through treatment in the case of foreign insurance companies and many foreign banks (which frequently are required by local regulatory requirements to organize in a form that would be a per se corporation). Nevertheless, Treasury and the IRS may wish to consider a definition that does not require a corporate parent if there is a non-corporate parent entity that is closely held.

12. An expanded affiliated group should be allowed to continue to own a historic limited FFI affiliate or limited branch, provided that the group implements appropriate safeguards, and to maintain accounts for local-country banks or insurance companies that are nonparticipating FFIs at least on a transitional basis.

Under the Proposed Regulations, a PFFI is treated as satisfying the all or nothing rule if its expanded affiliates group includes "limited FFI affiliates" or "limited branches." Broadly speaking, a limited FFI affiliate or limited branch is subject to restrictions under local law that prevent it both (1) from satisfying FATCA's reporting or passthru payment withholding rules, and also (2) from closing the accounts that the affiliate or branch cannot report or withhold upon.[144] The Proposed Regulations contemplate that the all or nothing rule will cease to be satisfied after December 31, 2015, if the limited FFI affiliates or limited branches have not met the requirements of the PFFI regime by that date.[145]

We believe that it would be appropriate to create a permanent exception to the all or nothing rule for certain limited FFI affiliates and limited branches. As noted above, the all or nothing rule appears to be based on the principle that PFFIs in an expanded affiliated group would be avoiding the intent of FATCA, if they could steer all of the group's recalcitrant clients to a nonparticipating affiliates within the group. In view of this intent, it appears that in the case of a group with a historically owned limited FFI affiliate or limited branch (i.e., one owned before the enactment of FATCA), it would be reasonable to allow that group to continue to own the affiliate or branch provided that appropriate safeguards are adopted. Specifically, final

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are included in other Code provisions which would have been obvious precedents for Congress to review when drafting Section 1471(e)(2); and grafting constructive ownership rules onto Section 1471(e)(2) would introduce a level of complexity that the statute does not appear to contemplate. Thus, we believe it would be helpful to clarify that the Section 958 constructive ownership rules do not apply for purposes of testing whether a partnership is a member of an expanded affiliated group.

144 Prop. Reg. §§ 1.1471-4(e)(2)(iii), (e)(3)(ii).

145 Prop. Reg. §§ 1.1471-4(e)(2)(vi) and (e)(3)(v).

regulations should require that the historically owned limited FFI affiliate or limited branch must have been subject to the relevant prohibitions under local law before the enactment of FATCA.[146] In addition, final regulations should provide that other group members must not refer any specified U.S. persons or U.S.-owned foreign entities to the limited FFI affiliate or limited branch to open any accounts and should also require that, to the extent permissible under local law, the limited FFI affiliate or limited branch must verify whether persons seeking to open new accounts are U.S. persons or U.S.-owned foreign entities and must refuse to open a new account for any such person. Final regulations also should mandate that the limited FFI affiliate or limited branch must diligently have applied for in good faith, and been denied by the local government, any waiver, ruling or other discretionary relief provided under local law from the prohibition that prevents the limited FFI affiliate or limited branch from meeting the requirements to be a PFFI.

If an expanded affiliated group meets these requirements, then it would appear that the group in fact is not seeking to structure itself in a manner that avoids the impact of FATCA, and thus is not implicating any of the concerns behind the all or nothing rule. Accordingly, there would appear not to be a strong policy reason to deny group members PFFI status if the group continues to own the historically held limited FFI affiliate or limited branch.

By comparison, there would seem to be at most a questionable advantage in effectively compelling a group to make a disposition of (or liquidate) its limited FFI affiliate or limited branch after December 31, 2015. Doing so would appear not to protect against a group's avoidance of the purposes of FATCA to a substantially greater extent than the approach described above, and also would appear to raise the possibility of a significant financial penalty for groups seeking to dispose of limited FFI affiliates or limited branches in jurisdictions where there are few potential buyers (for example, jurisdictions where the financial industry is small and consists largely of multinational groups with local presences, who may all be seeking to exit the market).

In addition, we do not believe that the treatment under the Proposed Regulations of "nonreporting members" of an expanded affiliated group as deemed-compliant FFIs is sufficient to address the issues described above. An FFI cannot qualify as a nonreporting member unless it identifies and closes, or transfers to an affiliate, its U.S. accounts and accounts held by nonparticipating FFIs. As indicated above in the discussion in Part I.C.3, these requirements may be in direct conflict with local law. Moreover, we believe these requirements are not

[146] We do not believe it generally would be appropriate to extend such relief to affiliates or branches in a country that adopted the relevant legal prohibition after the enactment of FATCA because such countries are likely to have been aware that the prohibition would conflict with FATCA's objectives. Final regulations could, however, grant discretion to the IRS to recognize local laws adopted after the enactment of FATCA in appropriate cases.

necessary to accomplish the goals of the all or nothing rule, in the case of a limited FFI affiliate or limited branch that is able to satisfy the requirements described above.

Finally, we request that Treasury and the IRS reconsider the requirement in the Proposed Regulations that no nonparticipating FFI accounts may be opened by a limited FFI affiliate or limited branch. In our view, this requirement may prove highly impractical. For example, consider a small country (Country X) with restrictive confidentiality laws most of whose banks are subsidiaries of large banks in another country. For the parent bank to become a PFFI, its subsidiaries in Country X would have to refuse to open accounts for any other FFIs in Country X. It is unclear how the financial system in Country X would be able to function in these circumstances. We suggest that, at least for a transition period, limited FFI affiliates and limited branches should be able to open and maintain accounts for same-country nonparticipating FFIs that are banks or insurance companies or otherwise are themselves limited FFI affiliates of an unrelated PFFI.

13. The all or nothing rule governing a PFFI in an expanded affiliated group should be made less restrictive, by permitting a group to include certain entities other than PFFIs and registered deemed-compliant FFIs (e.g., exempt beneficial owners).

While we support the goals of the all or nothing rule, we believe the rule is unduly restrictive as drafted in the Proposed Regulations. For example, the Proposed Regulations do not contain an exception for affiliation with an exempt beneficial owner (such as a government or central bank that owns a controlling stake in an FFI) and thus, read literally, appear to preclude PFFI status or registered deemed-compliant status for an FFI in such a case. We recommend that further consideration be given to relaxing the rule so that only those kinds of entities whose inclusion in an affiliated group would raise a substantial risk of the kind of abuse that the rule is designed to combat.

Comments on Verification and Audit Rules (Recommendation 14)

14. Coordinating a QI external audit with PFFI compliance verification should be optional for a PFFI.

The Preamble requests comments regarding the coordination of the external audit requirements for QIs, withholding foreign partnerships and withholding foreign trusts with the compliance verification procedures applicable to PFFIs.[147] We recommend that final regulations provide QIs, withholding foreign partnerships and withholding foreign trusts the option to either include PFFI compliance in otherwise required external audits or to follow the self-certification procedures otherwise available to PFFIs. Given the much broader scope of information that

[147] *See* Preamble at section XIX.B, 77 Fed. Reg. at 9041.

might be subject to an audit of FATCA compliance, we are concerned that requiring QIs, withholding foreign partnerships and withholding foreign trusts to cover these matters in their existing external audits could put them at a significant disadvantage to other PFFIs. Although we approve of the requirement that each such withholding agent be required to be a PFFI (to the extent it is legally able to do so), we do not think it is necessary to adopt a rule that might substantially increase the costs associated with status as a QI, withholding foreign partnership or withholding foreign trust.

Comments on Default and Termination Rules (Recommendation 15)

15. Final regulations should clarify what constitutes an event of default, the obligations of a "responsible officer" to report events of default to the IRS, and the consequences of an event of default.

As discussed above, an FFI agreement will define compliance failures that will constitute an event of default. A compliance failure will not constitute an event of default unless such failure occurs in more than limited circumstances when a PFFI has not substantially complied with its obligations under the FFI agreement.[148]

Further clarification would be helpful. The concept of an "event of default" implies that there will be specific triggers for termination of an FFI agreement and it will not merely be at the discretion of the IRS in a particular case to decide that termination is appropriate based on all the facts and circumstances. It would be helpful to spell out in regulations some of the factors that would distinguish the types of compliance failures that will or will not terminate PFFI status. Terminating events might include a sustained pattern of compliance failures, lack of substantial effort to correct compliance failures identified in the course of the internal verification process, willful or gross negligence by officers and senior employees in applying the FFI's chapter 4 procedures, or failure to correct a compliance failure following IRS notification. Inclusion of examples distinguishing limited compliance failures from compliance failures rising to the level of a default would also assist institutions and their advisors in gauging the types of conduct that may terminate PFFI status.

Regulations should also clearly explain the obligation of officers and employees of an FFI, in particular the "responsible officer," to report to the IRS any event of default or compliance failure that has been identified. Such individuals have fiduciary and other duties to the entity they represent, which may put them in a difficult position unless their reporting obligations to the IRS are clear and unambiguous.

Regulations should also clarify the remedies available to the IRS. We believe that these should be limited to termination of the FFI agreement in the case of default and existing statutory

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[148] Prop. Reg. § 1.1471-4(a)(7).

remedies, including but not limited to the imposition of interest and penalties on taxes that the PFFI fails to withhold in accordance with the FFI agreement.[149]

V. NFFEs

A. Background

A NFFE is defined in the Proposed Regulations as any foreign entity that is not an FFI.[150] Under Proposed Regulations section 1.1472-1, a withholding agent must withhold 30% of any withholdable payment to an NFFE unless three conditions are satisfied: (1) the NFFE, or another NFFE, is the beneficial owner of the payment; (2) the withholding agent can treat the NFFE or other NFFE as not having any substantial U.S. owners, or having properly identified its substantial U.S. owners; and (3) if the NFFE or other NFFE has substantial U.S. owners, the withholding agent reports certain information to the IRS as described under Proposed Regulations section 1.1472-1(e).[151] For this purpose, the Proposed Regulations define a "substantial U.S. owner" as a person that directly or indirectly owns more than 10% of the shares of the NFFE.

There are two exceptions to a withholding agent's obligation in respect of NFFEs, both of which depend on the identity of the recipient.[152] First, no withholding is required if the payee is either a withholding foreign partnership or a withholding foreign trust, in which case the partnership or the trust will be required to assume withholding responsibilities with respect to its partners, owners or beneficiaries. Second, no withholding is required if the beneficial owner of the payment is an "excepted NFFE", which includes. *inter alia*, (1) "publicly traded corporations" (or their affiliates), (2) "active NFFEs", (3) exempt beneficial owners listed in Proposed Regulations section 1.1471-6(b) through (g) and (4) excepted FFIs.[153]

Proposed Regulations section 1.1471-2(c)(1)(i)(C) defines a "publicly traded corporation" for this purpose as a corporation the stock of which is "regularly traded on one or more established securities markets." The standard for "regularly traded" includes trading

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[149] We believe it would be useful to address the issues just described in regulations rather than in the model FFI agreement or in other forms of guidance. Doing so will enhance the permanency and stability of the rules, with respect to issues where fixed, stable guidelines will be particularly important to taxpayers and to the IRS.

[150] Prop. Reg. § 1.1471-1(b)(36).

[151] Prop. Reg. § 1.1472-1(b)(1). The required information includes the name, address and TIN of each substantial U.S. owner. Prop. Reg. § 1.1472-1(e)(2).

[152] *See* Prop. Reg. § 1.1472-1(c).

[153] The rules for identifying the various categories of "excepted NFFEs" are found in Proposed Regulations section 1.1471-3(d)(11).

volume and frequency requirements, each closely resembling the requirements found under the branch profits tax and under Section 883.[154] An "established securities market" generally means a U.S. exchange registered under the 1934 Act or by the SEC, a foreign exchange recognized by the relevant foreign authority and exceeding a $1 billion trading threshold (as measured during the three preceding years), and further exchanges as designated by the Secretary.[155]

The requirements for qualifying as an "active NFFE" are described above in Part II.C, and the types of exempt beneficial owners and excepted FFIs are also described above, in Parts II and III. The Proposed Regulations define a "passive NFFE" as any NFFE that does not qualify as an excepted NFFE.[156]

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

1. As described in Part II, we believe that the concept of an "active NFFE" should be discarded in favor of a rule that considers the activities of an entire expanded affiliated group. If this recommendation is not accepted, however, then a number of changes should be made to clarify and broaden the definition of an active NFFE.

2. The test for whether an NFFE is publicly traded should be clarified to deal properly with companies recently listed on an exchange.

3. A passive NFFE's obligation to identify its substantial U.S. owners should be simplified. In addition, a passive NFFE that tries to identify all its substantial U.S. owners and fails because some of the owners do not cooperate should be subject to Section 1472 withholding only on such owners' pro rata share of a payment.

4. The definition of "U.S. account" should be modified to exclude an account owned by an excepted NFFE.

C. <u>Discussion</u>

1. As described in Part II, we believe that the concept of an "active NFFE" should be discarded in favor of a rule that considers the activities of an entire expanded affiliated group. If this recommendation is not accepted,

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154 *See* Treas. Reg. §§ 1.884-5(d)(4) and 1.883-2(d).

155 In addition, the Commissioner may designate a foreign exchange otherwise satisfying the above requirements as not an "established securities market" if the exchange does not have adequate listing, disclosure or trading requirements and there is not clear and convincing evidence that the exchange ensures the active trading of listed stocks. Prop. Reg. § 1.1472-1(c)(1)(i)(C).

156 Prop. Reg. § 1.1471-1(b)(36)(iii).

however, then a number of changes should be made to clarify and broaden the definition of an active NFFE.

As described above in Part II, we propose that entities that are members of an expanded affiliated group that is principally engaged in the active conduct of a nonfinancial trade or business would be excepted FFIs and also would be excepted NFFEs.

If this recommendation is not accepted, then we would propose that Treasury and the IRS modify the definition of an active NFFE in a manner consistent with several of our recommendations under Part II.C.4 above regarding categories of excepted FFIs.

a. Time Period for Measuring Status as an Active NFFE

Active NFFE status is currently tested on the basis of an entity's income and assets for the preceding year. In order to reduce the significance of unexpected, temporary swings in the composition of an entity's income or assets (and to make the test more consistent with the rules defining an Investment FFI), we would suggest lengthening the testing period to cover more than one year – say, three years.

In addition, the criteria for measuring an NFFE's assets (fair market value, U.S. tax basis, carrying value on the NFFE's financial statements) should be clarified.

b. NFFEs That Are Reorganizing, Liquidating or Emerging from Bankruptcy

A new category of excepted NFFE could be created, modeled on the corresponding category of excepted FFI, that covers NFFEs which do not qualify as active NFFEs and which have recently commenced an insolvency proceeding, begun a process of liquidating, or sold their historic active business with a plan of reinvesting the proceeds in a new active business. It is possible that a foreign entity will not be an FFI, and thus will not qualify for the category of excepted FFI that exists for insolvent, liquidating or reorganizing entities, but nevertheless will find itself in circumstances analogous to those described in such exception in the FFI regime.

c. Group Intellectual Property or Real Estate Holding Companies

Similar to the creation of a category of excepted FFI for group finance or hedging company members of an active nonfinancial group under the Proposed Regulations, we recommend that a member of a group that serves as an intellectual property holding company for the group qualify as an excepted NFFE if most or all of its income is attributable to royalties from group members that are themselves active NFFEs. Excepted NFFE status should also be available to a group member that leases real property to other members of the group if most or all of its income consists of rent from such members. As discussed in Part II.C.4.d, a framework would need to be developed for determining when a group is an active nonfinancial group in order to apply these new categories of excepted NFFEs.

2. *The test for whether an NFFE is publicly traded should be clarified to deal properly with companies that only recently listed on an exchange.*

We also propose modest changes to the test for an excepted NFFE that is a publicly traded corporation, all of which are designed to prevent a corporation from inadvertently failing the test. First, the test is an annual test that is based on a corporation's trading history for the preceding calendar year. Since a corporation that completes an initial public offering has no history of trading on an exchange in the preceding year, any such corporation would thus be automatically prevented from qualifying for publicly traded corporation status in the first year it is listed on an exchange. We believe a more appropriate result would be to deem the corporation to have satisfied the publicly traded test in such first year. This approach would be consistent with that taken in the limitation on benefits articles in several U.S. income tax treaties.[157] Second, we note that in the corporation's second year of public trading, some special treatment would be warranted; in order to take into account the fact that the corporation's listing may have occurred in the middle of the preceding year, it would be reasonable to prorate the numerical tests for regular trading[158] to reflect the portion of the year for which the shares were listed.[159] A third point for consideration is that instead of testing whether a corporation's stock is regularly traded based on the results for a single preceding year, the corporation's trading results over a period of multiple prior years could be averaged, in order to help eliminate the effects of one year of unusually low (or high) trading volume.

3. *A passive NFFE's obligation to identify its substantial U.S. owners should be simplified. In addition, a passive NFFE that tries to identify all its substantial U.S. owners and fails because some of the owners do not cooperate should be subject to Section 1472 withholding only on such owners' pro rata share of a payment.*

We suggest that the rules for attribution of ownership for purposes of identifying a passive NFFE's substantial U.S. owners should be clarified and simplified in several respects. In addition, we recommend that the Proposed Regulations be revised to incorporate more administrable procedural steps to allow a passive NFFE to identify its substantial U.S. owners.

The attribution rules generally attribute stock or other equity of a passive NFFE to the owners of a corporation, partnership or trust on a proportionate basis. While the Proposed Regulations state that "all relevant facts and circumstances" will be used to determine an owner's

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157 *See* Protocol to the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, U.S.-Ir., July 28, 1997, Art. 9(a)(i)(B).

158 *See* Prop. Reg. § 1.1472-1(c)(1)(i)(A).

159 *See* Treas. Reg. § 1.884-5(d)(4)(i)(B).

proportionate interest,[160] we recommend a clearer standard. Generally, fair market value (determined on the basis that each share of a particular class has the same fair market value) would be an appropriate standard.[161] In the case of a passive NFFE that is a corporation, in addition to ownership of more than 10% by value of the corporation's stock, ownership by a U.S. person of more than 10% or more by voting power of the NFFE's stock also would qualify the person as a substantial U.S. owner, consistent with the statute.

In addition, the Proposed Regulations' reference to arrangements that "artificially" decrease a specified U.S. person's proportionate interest is unclear. This may be a reference to cases in which a specified U.S. person, for example, does not own the actual shares of an NFFE but holds contingent debt or a derivative with economics that track the shares of an NFFE. In the case of a corporation, there may be arrangements to convey control to a specified U.S. person that does not possess the right to vote for directors in its capacity as a shareholder.[162] If these are the types of arrangements that concern Treasury and the IRS, we suggest this be expressly stated.

We also believe the attribution rules in their current form impose a substantial burden on NFFEs that could be alleviated without sacrificing the basic due diligence purpose underlying those rules. Although a "substantial U.S. owner" of a passive NFFE is defined as a specified U.S. person that owns over 10% of the NFFE, the Proposed Regulations require an NFFE generally to look through every entity that directly or indirectly owns any of the NFFE's shares and identify each of the owners of that shareholder entity, for purposes of determining whether there is any specified U.S. person whose direct and/or indirect interest in the NFFE exceeds the 10% ownership threshold. For an NFFE with a tiered ownership structure involving a significant number of small owners, this requires a considerable effort. For example, suppose that an NFFE has 40 direct shareholders (the Direct Shareholders), each of which is a foreign entity that owns 2.5% of the NFFE's shares; and suppose that Z, a specified U.S. person, owns (directly or through intermediate holding companies) 40% of the equity interest in each of Direct Shareholders 1 through 11. Z would be a substantial U.S. owner of the NFFE, under the Proposed Regulations. (Z owns 11 X 40% X 2.5% = 11% ownership of the NFFE.) In theory, an NFFE would be required to perform sufficient due diligence to identify Z as a substantial U.S. owner.

By comparison, we believe that if an NFFE is permitted to limit its inquiry to any entity that directly owns over 10% by fair market value of the NFFE's shares or that indirectly (through

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160 Prop. Reg. § 1.1473-1(b)(2)(v).

161 Section 1473(2)(A)(i) refers to fair market value as an appropriate measure of relative ownership in the context of a corporation's stock and the statutory references in Section 1473(2)(A)(ii) and (iii) to 10% of the capital or profits interests in the case of a partnership, or 10% of the interest in a trust (other than a grantor trust), are consistent.

162 *Cf. Alumax Inc. v. Comm'r*, 109 T.C. 133 (1997), *aff'd*, 165 F.3d 822 (11th Cir. 1999).

a single chain of ownership going through a single direct shareholder of the NFFE) owns over 10% of the NFFE's shares, that is likely to meaningfully simplify the NFFE's obligations. The suggested approach would be analogous to the approach taken in the Section 382 regulations, which generally require a loss corporation only to determine the ownership of an entity that directly or indirectly (through a single chain of ownership) holds 5% or more of the loss corporation's stock, for purposes of identifying the loss corporation's 5% shareholders.[163] (Similar to the Section 382 regulations, the regulations under Section 1473 could supplement the rule just described by requiring an NFFE to take into account any facts actually known to the NFFE about ownership of the NFFE's shares directly or indirectly by a specified U.S. person.)[164]

In addition, if a passive NFFE has as one of its direct or indirect shareholders an excepted NFFE, then the passive NFFE should have no obligation to look through that excepted NFFE when identifying the substantial U.S. owners of the passive NFFE. An excepted NFFE could receive payments directly free of FATCA withholding tax, without having due diligence obligations with respect to its substantial U.S. owners. There seems to be no reason to impose such due diligence obligations on a lower-tier passive NFFE in which the excepted NFFE owns an interest.

In addition to clarifying the ownership attribution rules, we also suggest that a framework be put into place in order to guide an NFFE through the process of identifying its substantial U.S. owners. The regulations should specify what types of documentation an NFFE is entitled to rely on to establish the status of a direct or indirect owner as U.S. or foreign, and as an individual or entity. Presumably the documentation requirements here would essentially track those applicable to withholding agents under Proposed Regulations section 1.1471-3.[165] In addition, the regulations should explain how an NFFE can establish the percentage that a person owns in an entity that is, in turn, an owner of an interest in the NFFE. It would seem that giving a choice to an NFFE of relying on a certification by such person or by the entity in which such person owns an interest, or relying on a preexisting shareholder register or similar document, would be reasonable.

If a direct or indirect shareholder of an NFFE does not comply with an NFFE's request for information, then it would seem the NFFE should be able to rely on the presumptions in Proposed Regulations section 1.1471-3(f) in order to establish the shareholder's status. In such a case, the NFFE will not be able to obtain sufficient information about any persons investing in

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163 *See* Treas. Reg. §§ 1.382-2T(g)(2), (g)(3), (k)(3).

164 *See* Treas. Reg. § 1.382-2T(k)(2).

165 In particular, if an upper-tier passive NFFE certifies in the manner described in Proposed Regulations section 1.1471-3 to a lower-tier passive NFFE that the upper-tier NFFE has no substantial U.S. owners, the lower-tier NFFE should be entitled to rely on that certification without further investigating the upper-tier NFFE's direct and indirect owners.

the NFFE through such shareholder, in order to determine whether any of those persons is a substantial U.S. owner; and thus the NFFE will not be able to certify to withholding agents that it has identified all of its substantial U.S. owners, or that it has no such owners, as required under the Proposed Regulations to avoid withholding. This appears to be a harsh outcome for a case in which an NFFE has made a good faith attempt to obtain the necessary information about its owners, and has very possibly largely succeeded with only a few holdouts over which it might have no control. A fairer outcome in such a case might be to give the NFFE the option of certifying to a withholding agent the percentage of the NFFE's shares held (directly or indirectly) by shareholders from which the NFFE has not received information. The withholding agent would then only be required to withhold a percentage of any payments it makes to the NFFE equal to the percentage ownership of the NFFE by such shareholders. In a case where the percentage ownership of noncompliant owners is very small, it may be appropriate to completely eliminate the Section 1472 withholding tax. In this connection, we note that it would not be surprising to find that at least some small foreign shareholders of an NFFE who have no connection to the United States might simply ignore the NFFE's (repeated) requests for U.S. tax documentation.

As a final point, we note that even if the above proposals are adopted, it often will be the case that an NFFE will need to expend significant time and effort in order to obtain enough information about its investors to certify as to its substantial U.S. owners. The Proposed Regulations would potentially require an NFFE to repeat this process every time it must certify its status to a new withholding agent, because such certification generally must include a list of the NFFE's substantial U.S. owners.[166] If the standards in Proposed Regulations section 1.1471-3 are imported into the NFFE regime, then a rule could be adopted under which a passive NFFE may rely on certifications provided to it for at least three years (unless notified of a change of circumstances by a direct or indirect shareholder), for purposes of the NFFE's own certifications to withholding agents. This would follow the approach taken under Proposed Regulations section 1.1471-3.[167]

4. The definition of "U.S. account" should be modified to exclude an account owned by an exempted NFFE.

The Proposed Regulations define a "U.S. account" to include any account held by a U.S. owned foreign entity, which in turn is defined as any foreign entity with one or more substantial U.S. owners.[168] There is no exclusion for a foreign entity that is an excepted NFFE, with the

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166 *See* Prop. Reg. § 1.1471-3(d)(11)(vi)(D).

167 *See* Prop. Reg. § 1.1471-3(c)(6)(ii)(A) (cross-referencing Treasury Regulation section 1.1441-1(e)(4)(ii)(A)-(C), and thus generally providing for a 3-year validity period and in some cases an indefinite validity period for a withholding certification).

168 *See* Prop. Reg. §§ 1.1471-5(a)(2), (c)(1).

result that for any account held by an excepted NFFE, a PFFI appears to be required by the Proposed Regulations to determine whether the excepted NFFE has any substantial U.S. owners, and thus whether the excepted NFFE's account is a U.S. account on which the PFFI is required to report under its FFI agreement. (For this purpose, if the PFFI is an Investment FFI or an insurance company, it must treat a U.S. person holding any amount of the equity of the excepted NFFE account holder as a substantial U.S. owner.)[169] The effect of these rules is that although the excepted NFFE is not itself subject to obligations to identify or report its substantial U.S. owners under Section 1472, a PFFI through which the excepted NFFE holds investments is obligated to identify such owners and report with respect to them. We believe it may not have been intended that the Proposed Regulations would impose this obligation on PFFIs; and in our view, clarifying in final regulations that PFFIs are not subject to such an obligation would not impair the effectiveness of the regulations.[170] (Indeed, we note that in at least some cases, it would be impossible as a practical matter for a PFFI to comply with the type of obligation just described. For example, in the case of an Investment FFI or insurance FFI that has an account held by a publicly traded NFFE, the NFFE may have at least a handful of small U.S. shareholders at any given time; but the PFFI and the NFFE may well have no way to determine reliably whether this is the case or the identity of such U.S. shareholders.)

We therefore recommend that final regulations specifically carve out from the definition of U.S. account an account held by an excepted NFFE.

VI. Payments Subject to Withholding

A. Background

FATCA withholding applies to payments of U.S. source FDAP income and gross proceeds from the sale or other disposition of property "of a type" that can produce U.S. source interest or dividends.[171] The determination of U.S. source FDAP income for FATCA purposes generally follows the rules governing withholding of tax under Section 1441; however, the Proposed Regulations contain a few exceptions.[172] They also provide that payments made in the

[169] *See* Prop. Reg. § 1.1473-1(b)(5).

[170] This point is generally similar to the suggestion that we made above in recommendation 3, to the effect that a passive NFFE should not be required to look through a shareholder that is an excepted NFFE in order to identify substantial U.S. owners of the passive NFFE.

[171] We have discussed foreign passthru payments above in Part IV, and as a result the recommendations in this section deal only with withholdable payments.

[172] Prop. Reg. § 1.1473-1(a)(2)(i).

ordinary course of a withholding agent's business for nonfinancial services, goods and the use of property are carved out from the definition of withholdable payment.[173]

With respect to gross proceeds withholding, the Proposed Regulations provide that property is of a type that can produce interest or dividends that are U.S. source FDAP when "the property is of a type that ordinarily gives rise to the payment of interest or dividends constituting U.S. source FDAP income, regardless of whether any such payment is made during the period such property is held by the person selling or disposing of such property."[174] The Proposed Regulations then give an example that stock of a U.S. corporation is property that can produce U.S. source dividends if a dividend from such corporation would be U.S. source, regardless of whether the corporation has ever paid a dividend or plans to do so.[175]

B. Summary of Recommendations

1. Final regulations should clarify that gross proceeds from the disposition of foreign stock or debt will not be a withholdable payment.

2. Final regulations should broaden the scope of "ordinary course of business payments" to cover more than just payments for services, goods and the use of property in the ordinary course of businesses. In addition, the distinction between fees for "financial" and "nonfinancial" services should be eliminated.

C. Discussion

1. Final regulations should clarify that gross proceeds from the disposition of foreign stock or debt will not be a withholdable payment.

Dividends and interest payable on foreign stock or debt can, in limited circumstances, be U.S. source. Specifically, Section 861(a)(2)(B) provides that, unless less than 25% of a foreign corporation's gross income over the past three years has been effectively connected with a U.S. trade or business, any dividend paid by the corporation will be partially U.S. source. The portion of the dividend that is U.S. source will bear the same ratio to the total dividend as the corporation's gross income effectively connected with the conduct of a U.S. trade or business arising during the past three years bears to the corporation's total gross income arising during

173 Prop. Reg. § 1.1473-1(a)(4)(iii). This carveout includes interest on accounts payable for nonfinancial services, goods and other tangible property. Section 1473 and the Proposed Regulations also contain carveouts from the definition of withholdable payment for payments of interest on short-term obligations, payments of effectively connected income, payments from sale of property that gives rise to payments of U.S.-source FDAP that are carved out from the definition of withholdable payments, and payments in lieu of fractional shares. Prop. Reg. §§ 1.1473-1(a)(4)(i), (ii), (iv), (v).

174 Prop. Reg. § 1.1473-1(a)(3)(ii)(A).

175 *Id.*

those three years. In addition, Section 861(a)(2)(C) provides that a dividend paid by a foreign corporation is U.S. source to the extent it is paid out of U.S. source earnings and profits.[176] Furthermore, Sections 884(f)(1)(A) and Treasury Regulations section 1.861-2(a)(2) provide that debt issued by a foreign corporation or partnership generally will give rise to interest payments that are U.S. source at least in part, if the issuer conducts a U.S. trade or business.

It is not clear whether Congress intended to subject gross proceeds from dispositions of foreign stock or debt to withholding under FATCA, although Section 1473(1)(A)(ii) appears literally to create an opportunity for such withholding, by defining a withholdable payment to include gross proceeds from the disposition of any "property of a type which can produce interest or dividends from sources within the United States." The Joint Committee on Taxation's report on the HIRE Act does not reflect consideration of this point, stating only that the statute covers proceeds from the sale of a derivative that is described in Section 871(m) (broadly, a derivative providing the holder with the economics of owning stock of a dividend-paying U.S. corporation).[177] The Proposed Regulations' reference to property "of a type that ordinarily gives rise" to U.S. source dividends or interest could reasonably be read to exclude foreign stock and debt, on the rationale that these types of assets do not as a class "ordinarily" give rise to U.S. source dividend or interest income.[178] We believe this result would make sense for a number of reasons, and we suggest that final regulations expressly confirm this result.

First, the number of foreign issuers of stock and debt whose dividend or interest payments would be sourced from within the U.S. is small, when compared with the overall number of foreign issuers. Since a nonparticipating FFI is able to hold and sell stock and debt of most foreign issuers without the prospect of FATCA withholding, it would be at best of limited use to treat gross proceeds from the sale of stock or debt of a narrowly circumscribed group of foreign issuers (those that generate U.S. source dividends or interest) as withholdable payments. Second, the principal objective of FATCA is information reporting rather than withholding and foreign entities that pay U.S. source dividends or interest to an FFI are required under the

[176] Although a foreign corporation thus can pay a U.S. source dividend, in practice it is rare for a foreign shareholder not engaged in a U.S. trade or business to be subject to U.S. tax on such a dividend. Section 884(e)(3)(A) provides that a foreign recipient of a U.S. source dividend paid by a foreign corporation will not be subject to U.S. gross-basis tax on that dividend, so long as the distributing corporation has paid branch profits tax on the earnings and profits being distributed.

[177] J. COMM. ON TAX. REP. 4-10, at 45 (2010).

[178] The example in the Proposed Regulation states that stock of a U.S. corporation falls within the scope of gross proceeds withholding if a dividend "from such corporation" would be U.S. source, regardless of whether the corporation actually has paid or will pay a dividend. Because under current law a dividend paid by any U.S. corporation would be U.S. source, it is hard to read "from such corporation" in the example as standing for the proposition that an examination of the particular issuer of the stock or debt that is sold is needed. Instead, the example seems concerned with confirming that it is irrelevant whether the U.S. corporation whose stock is sold in fact has paid, or will pay, any dividends. Prop. Reg. § 1.1473-1(a)(3)(ii)(A).

Proposed Regulations to report those payments, whether or not any FATCA withholding is imposed.[179] Thus, holders of foreign stock or debt giving rise to such payments would be subject to chapter 4 information reporting, regardless of whether proceeds from the disposition of such stock or debt is a withholdable payment. Finally, as a practical matter, it would often be impossible for a buyer of foreign stock or debt to determine whether withholding on the sale price is necessary because the buyer would lack reliable information about whether the issuer of the stock or debt satisfies the prerequisites for dividends or interest paid by such issuer to be U.S. source.

Accordingly, we suggest that final regulations clarify that gross proceeds from a disposition of foreign stock or debt will not be subject to withholding under chapter 4.

2. Final regulations should broaden the scope of "ordinary course of business payments" to cover more than just payments for services, goods and the use of property in the ordinary course of businesses. In addition, the distinction between fees for "financial" and "nonfinancial" services should be eliminated.

The Proposed Regulations exclude "ordinary course of business payments" from withholdable payments.[180] The intent of the Proposed Regulations appears to be to prevent a withholding agent's normal operational expenses from being withholdable payments.[181] Although we agree that these payments should not be subject to withholding, we believe the definition provided in the Proposed Regulations is too narrow. It is limited to nonfinancial services, goods, and the use of property, which excludes many types of payments that occur in the ordinary course of business such as taxes, regulatory fees, damages, etc. We recommend that the definition of "ordinary course of business payments" be expanded in final regulations to cover all payments incurred in the ordinary course of the withholding agent's business (regardless of whether those payments are fees for services, the price of goods purchased, rent or royalties, or any other type of expenditure), except for dividends, interest and other types of payments expressly excluded from the "ordinary course" category in those regulations.

In this regard, the Proposed Regulations provide little guidance as to when a fee is for financial services, and thus excluded from the scope of ordinary course payments. The Proposed Regulations indicate that brokerage fees and bank fees are payments for financial services and,

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179 *See* Prop. Reg. § 1.1474-1(d).

180 Prop. Reg. § 1.1473-1(a)(4)(iii).

181 The reference to the withholding agent's trade or business is appropriate, in a case where the withholding agent directly pays an FFI or NFFE. Presumably, in a case where the payor makes a payment to an FFI or NFFE through an intermediary which is a withholding agent, the intent is to refer to the payor's trade or business, rather than that of the intermediary.

thus, are not ordinary course payments; but not much other guidance is provided. For example, it is not entirely clear whether payments for financial services include fees for bookkeeping or auditing, for subscription services giving data on pricing or conditions in securities or commodities markets or other financial information, for investment advice, for investment banking services, estate planning, or custodial or trust services.

Rather than attempt to define more precisely the concept of a fee for financial services, we suggest that final regulations instead could focus on the question of whether fee payments have been made effectively as a substitute for other payments which would be withholdable payments incurred outside the ordinary course of business. For example, a fee for services could be treated as a non-ordinary course payment if (1) the party receiving the services has contemporaneously entered into a transaction with the service provider that results in the service recipient making withholdable or passthru payments (e.g., a loan) and (2) the parties would not have entered into their service arrangement without also contemporaneously entering into such other transaction. In such a case, the payments for services could be viewed as proxy for withholdable payments or passthru payments that are subject to FATCA withholding; and it would be appropriate to exclude such payments for services from the scope of ordinary course payments.

We believe this recommended approach would provide greater certainty that normal business expenses are not withholdable payments, without compromising the policy objectives of the statute.

Finally, we suggest that final regulations clarify that obligations of an FFI to make ordinary course of business payments are not financial accounts. As evidenced by the carveout of such payments from the definition of withholdable payment, such payments have a low potential for the types of abuse that FATCA is designed to reach. It does not appear that Treasury or the IRS intended to require reporting by an FFI with respect to obligations to make these payments. We therefore recommend that the definition of a debt interest in a financial institution in Proposed Regulations section 1.1471-5(b)(1)(iii) be clarified to exclude such obligations.[182]

VII. Mechanics for Withholding under Sections 1471 and 1472

A. Background

1. Withholding

[182] If our recommendation in Part IV.C.7 to limit foreign passthru payments to payments on financial accounts is accepted, then the clarification proposed in the text will have the effect of removing ordinary course of business payments by an FFI from the scope of foreign passthru payment withholding, which we believe is appropriate

The Proposed Regulations require withholding agents to begin withholding on payments of U.S. source FDAP to payees that are nonparticipating FFIs beginning in 2014,[183] and on payments of gross proceeds to payees that are nonparticipating FFIs beginning in 2015,[184] and to electronically deposit withheld amounts with the IRS in the same manner as under chapter 3.[185] A withholding agent may credit the amount required under chapter 4 to be withheld from a payment against the withholding agent's chapter 3 withholding obligation.[186]

In Notice 2011-53, the IRS stated that withholding obligations under Sections 1471(a) and 1472(a) would not begin until January 1, 2014. Although the Proposed Regulations delay the effective date for withholding with respect to nonparticipating FFIs, no delay appears to have been granted in the Proposed Regulations with respect to withholding on payments of U.S. source FDAP income to non-exempt NFFEs. The Proposed Regulations by their terms appear to require withholding on payments of U.S. source FDAP income to non-exempt NFFEs beginning on January 1, 2013.

Similar to the rules under chapter 3 of the Code, a withholding agent generally will be permitted to rely on the information contained in forms it receives unless it has "reason to know" that the information is incorrect.[187] In addition to a number of indicators that give rise to a reason to know that information is incorrect, the Proposed Regulations impose affirmative due diligence requirements on withholding agents that receive a Form W-8 from an FFI that claims an exemption from FATCA withholding.

Payment to an NFFE free of withholding tax requires a valid Form W-8BEN identifying the payee as an NFFE and a certification that it does not have any substantial U.S. owners, or that provides the name, address, and TIN of each of its substantial U.S. owners.[188] If the payee is a certified deemed-compliant FFI, the withholding agent must receive backup documentation along with a properly completed Form W-8.[189] However, if a withholding agent receives a Form

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183 Prop. Reg. § 1.1471-2(a)(1).

184 Prop. Reg. § 1.1473-1(a)(1)(ii).

185 Prop. Reg. § 1.1474-1(b). These rules generally require weekly or monthly electronic deposits to be made through the Electronic Federal Tax Payment System. *See* Treas. Reg. § 1.6302-2; Treas. Reg. §§ 31.6302-1(h)(2)(iii) and (5).

186 Prop. Reg. § 1.1474-6(b). An amount subject to withholding under Section 1445 or Section 1446 is not subject to chapter 4 withholding. The Proposed Regulations reserve on the treatment of amounts subject to withholding under both Section 3406 and chapter 4.

187 Prop. Reg. § 1.1471-3.

188 Prop. Reg. § 1.1471-3(d)(11)(D).

189 Prop. Reg. §1.1471-3(d)(6) (providing certification required for retirement plans, non-profit organizations, and FFIs with only low-value accounts.

W-8 with a claim that a recipient is a PFFI or registered deemed complaint FFI, the withholding agent has 90 days to confirm that the person's name and the FFI-EIN they provided appear on an "FFI list" the IRS is going to publish.[190] Furthermore, chapter 4 effectively requires withholding agents to check the payee's status on the IRS FFI list at least once each year.[191] Neither of these obligations exists under chapter 3.

As under chapter 3, the Proposed Regulations provide presumptive rules for withholding agents to apply when they do not receive valid forms.[192] If withholding is required, the withholding agent is required to electronically deposit the amount withheld with the IRS in the same manner as under chapter 3.[193] Each withholding agent is liable for the tax that should have been withheld under chapter 4 and is indemnified against the claims of any person for the amount of any tax it deducts and withholds under a reasonable belief that withholding was required.[194]

2. Refunds and Credits

The Proposed Regulations permit a payee that is a nonparticipating FFI or a non-exempt NFFE to obtain a refund of chapter 4 taxes if the payee is entitled to treaty benefits with respect to the item of income.[195] To obtain a refund or credit on the basis of a tax treaty, a nonparticipating FFI or a non-exempt NFFE must file a tax return and claim a refund or credit with respect to the withheld taxes on that tax return.[196]

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190 Prop. Reg. § 1.1471-3(d)(3)(i); Prop. Reg. § 1.1471-3(e)(3). Special transition rules apply to payments before 2016 and 2017 respectively. Prop. Reg. §§ 1.1471-3(e)(3)(ii) (before 2016), 1.1471-3(d)(3) (before 2017).

191 Prop. Reg. § 1.1471-3(e)(3). The Proposed Regulations do this by providing that a withholding is deemed to know of an FFI's removal from the IRS FFI list one year after the FFI's name is removed from the list.

192 Prop. Reg. § 1.1471-3(f).

193 Prop. Reg. § 1.1474-1(b). These rules generally require weekly or monthly electronic deposits to be made through the Electronic Federal Tax Payment System. *See* Treas. Reg. § 1.6302-2; Treas. Reg. §§ 31.6302-1(h)(2)(iii) and (5).

194 Prop. Reg. §§ 1.1474-1(a)(2) and (f).

195 Prop. Reg. § 1.1474-5(a). A non-exempt NFFE is also entitled to a refund if it provides required documentation regarding its owners.

196 Prop. Reg. § 1.1474-5(a); *see also* J. COMM. ON TAX. REP. 60-09, at 136 (2009) ("U.S. income tax treaties do not require the United States and its treaty partners to follow a specific procedure for providing treaty benefits. . . . [T]he United States may require withholding at the relevant statutory rate at the time of payment and allow treaty country residents to obtain treaty benefits through a refund process. The credit and refund mechanism ensures that residents of treaty partners continue to obtain treaty benefits in the event tax is withheld under the provision.").

The Proposed Regulations do not set forth any procedure for a payee to claim a reduced treaty rate of withholding by the payor on a withholdable payment or passthru payment. Nor do they expressly prohibit a payee from making such a claim as an alternative to being subjected to withholding at the full 30 percent rate and then filing a claim for a refund.

3. Information Reporting

Under the Proposed Regulations, beginning in 2014, every withholding agent is required to report to the IRS on Form 1042-S each payment of (i) U.S. source FDAP income made to a foreign recipient, whether or not the payment is subject to withholding under chapter 4, (ii) gross proceeds that are subject to withholding under chapter 4, and (iii) foreign passthru payments that are subject to withholding under chapter 4.[197] The Proposed Regulations provide several examples demonstrating when payees are "recipients" with respect to which the withholding agent must report a payment under this rule. These examples generally are consistent with the Form 1042-S reporting rules under chapter 3.

B. Summary of Recommendations

1. Final regulations should conform the delayed effective date for withholding on payments to non-exempt NFFEs to the delayed effective date for withholding on payments to FFIs, by providing that withholding on payments of U.S. source FDAP income to non-exempt NFFEs will not begin until January 1, 2014, as stated in Notice 2011-53.

2. A "reason to know" safe harbor should be included for financial institutions. This could be modeled on the safe harbor in chapter 3.

3. The requirement that a withholding agent check a payee's EIN against the IRS FFI list when the payee claims it is a PFFI or registered deemed-compliant FFI should be modified in a manner that simplifies compliance by withholding agents.

4. Final regulations should clarify that the statutory indemnification of withholding agents is a claim against the United States, including a claim for any liability attributable to withholding on foreign passthru payments, and should describe the procedure for making such a claim.

5. PFFIs should be provided with an alternative method of depositing withheld amounts.

6. The principles of a hypothetical transaction under Treasury Regulation section 1.743-1(d) should apply in order to determine the amount of gross proceeds subject to FATCA withholding for partnerships and other flow through entities.

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[197] Prop. Reg. § 1.1474-1(d). The withholding agent must file a separate Form 1042-S for each recipient of an amount subject to reporting and for each separate type of payment it makes, and must furnish each recipient with a Form 1042-S, which may reflect more than one type of payment.

7. The withholding procedures relating to payments of gross proceeds should conform to the withholding procedures for payments of U.S. source FDAP income.

8. Final regulations should provide a refund of gross proceeds withholding to a nonparticipating FFI or non-exempt NFFE that is eligible for the benefits of a tax treaty. Final regulations should also provide a refund of passthru payment withholding to a nonparticipating FFI that is eligible for the benefits of a treaty.

C. Discussion

1. Final regulations should conform the delayed effective date for withholding on payments to non-exempt NFFEs to the delayed effective date for withholding on payments to FFIs, by providing that withholding on payments of U.S. source FDAP income to non-exempt NFFEs will not begin until January 1, 2014, as stated in Notice 2011-53.

As discussed above, the Proposed Regulations delay withholding on payments of U.S. source FDAP income to nonparticipating FFIs until January 1, 2014. However, as drafted, the Proposed Regulations appear not to delay the effective date with respect to withholding of U.S. source FDAP income paid to non-exempt NFFEs, even though Notice 2011-53 provided that such withholding would not begin until January 1, 2014.[198] No indication has been given that the IRS has reconsidered the determination made in Notice 2011-53. To eliminate uncertainty, we recommend that final regulations clarify that the same phased-in withholding schedule governing payments of U.S. source FDAP income to FFIs also apply to NFFEs.

2. A "reason to know" safe harbor should be included for financial institutions. This could be modeled on the safe harbor in chapter 3.

Treasury Regulation section 1.1441-7(b)(3) provides that, for purposes of chapter 3, a financial institution does not have "reason to know" that an account holder's claim of foreign status on a withholding statement is inaccurate so long as:

1. there is no intermediary between the financial institution and the account holder;
2. the payment is of (i) dividends or interest on actively traded stock or debt instruments, (ii) dividends on redeemable mutual fund stock, (iii) interest, dividends or royalties on publicly offered units in a unit investment trust, or (iv) any payments on loans of these securities;

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198 Because gross proceeds from any sales occurring before 2015 are excluded from the definition of "withholdable payment," gross proceeds withholding on non-exempt NFFEs under the Proposed Regulations would begin at the same time as gross proceeds withholding on noncompliant FFIs. *See* Prop. Reg. § 1.1473-1(a)(1)(ii).

3. the withholding certificate is not incomplete or inconsistent with the account holder's claim of foreign status or with other information that the financial institution has on file; and

4. the withholding certificate or account holder has not provided a U.S. address or standing instructions directing the withholding agent to pay amounts to an address or account maintained in the United States.

The preamble to the Section 1441 regulations explains that this "safe harbor" is appropriate "in the context of high-volume commercial transactions where there is not necessarily a pre-existing client relationship."[199]

The safe harbor is complemented in the Section 1441 regulations by rules stating that, if the circumstances described in 3 or 4 above are present, then the withholding agent does have reason to know that a withholding statement from the payee claiming foreign status is inaccurate.[200]

The Proposed Regulations under chapter 4 do not provide any analogous safe harbor for when a financial institution does not have "reason to know." Instead, the Proposed Regulations only contain rules corresponding to those in the Section 1441 regulations that set forth specific circumstances in which a withholding agent will be treated as having "reason to know" it cannot rely on a claim of foreign status in a withholding statement.

We recommend that final regulations include a safe harbor for financial institutions for establishing that they do not have reason to know that a withholding statement or other required documentation is inaccurate. A safe harbor for commonplace transactions would significantly enhance the administrability of the FATCA withholding regime. We believe that such a safe harbor could be modeled on similar safe harbor under the Section 1441 regulations. We are not aware of any reason why this safe harbor would not work just as effectively under chapter 4 as under chapter 3. Moreover, applying the same "reason to know" standard in chapter 4 as in chapter 3 would permit withholding agents to develop and maintain uniform compliance systems.

3. The requirement that a withholding agent check a payee's EIN against the IRS FFI list when the payee claims it is a PFFI or registered deemed-compliant FFI should be modified in a manner that simplifies compliance by withholding agents.

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[199] Regulations Relating to Withholding of Tax on Certain U.S. Source Income Paid to Foreign Persons and to Information Reporting and Backup Withholding, 62 Fed. Reg. 53387, 53411 (October 14, 1997).

[200] *See* Treas. Reg. § 1.1441-7(b)(4)-(9).

As discussed above, a withholding agent is deemed to have reason to know that a payee is not in fact a participating or registered deemed-compliant FFI if the payee's name and FFI-EIN do not appear on a published IRS FFI list, or if more than one year has elapsed since the payee was removed from the list. Therefore, chapter 4 effectively requires withholding agents to check the FFI list at least once each year with respect to each payee. Chapter 3 does not similarly impose a requirement to independently reconfirm the eligibility of a payee for a withholding exemption.

It is unclear to us why chapter 4 should impose materially more burdensome due diligence requirements on withholding agents than those imposed under chapter 3.[201] We are not aware of any widespread problems involving fraud under chapter 3, and the Preamble does not suggest any such problem exists.[202] In addition, similar to Treasury Regulations section 1.1441-1(e)(4)(ii)(D), the Proposed Regulations require a payee to inform the withholding agent within 30 days of any change in circumstances that causes any information on a withholding certificate to become incorrect.[203] In light of this, Treasury and the IRS may wish to reconsider whether a withholding agent should be required to check a payee's EIN on an annual basis against the IRS's FFI list when the payee claims that it is a PFFI or registered deemed-compliant FFI. If the requirement for an annual check against the IRS's list is retained, we recommend that the IRS develop a notification system that permits a withholding agent to request and receive an email or other correspondence upon the removal of an FFI from the list.

Alternatively, the IRS could publish annually in a searchable format the names and EINs of those FFIs that had ceased to qualify as PFFIs or registered deemed-compliant FFIs during the preceding year and require withholding agents to consult such list.

4. Final regulations should clarify that the statutory indemnification of withholding agents is a claim against the United States, including a claim for any liability attributable to withholding on foreign passthru payments, and should describe the procedure for making such a claim.

As described above, Section 1474(a) and the Proposed Regulations provide that a withholding agent is indemnified against any claims that result from its withholding of tax under

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201 Because a payee that claims certified deemed-compliant FFI status is not required to register with the IRS, we believe that it is appropriate to require the payee in this context to provide supporting documentation to a withholding agent.

202 Indeed, the Preamble provides that chapter 4 is intended to "extend[] the scope" of the already "comprehensive" U.S. information reporting regime. Preamble, 77 Fed. Reg. at 9022.

203 Prop. Reg. § 1.1471-3(c)(6)(ii)(D)(2).

chapter 4. This indemnity is analogous to the one provided to withholding agents under chapter 3.[204]

The scope of this indemnity should be clarified in final regulations. We are not aware of any case law or other administrative guidance that provides a detailed explanation of the indemnity in Section 1461 for a chapter 3 withholding agent, on which the language of the chapter 4 indemnity is based; and commentators have recognized that the Section 1461 indemnity gives rise to a number of interpretive questions.[205] In the context of chapter 4, we believe it will be useful to clarify the procedures governing these indemnities. Because the types of withholding required under chapter 4 (in particular on foreign passthru payments) are novel, it is not yet fully understood to what extent foreign persons will be able to bring claims against withholding agents under applicable foreign law. In addition, in some commercial transactions the parties' contractual arrangements may not allocate the risk and economic burden of FATCA withholding among them in a precise and predictable manner, particularly during the next several years when the impact of the FATCA regime on a range of different types of transactions will first be tested. Final regulations should expressly state that if a withholding agent incurs liability for FATCA withholding, the withholding agent is entitled to indemnification from the U.S. government. Final regulations should also describe the procedure that a withholding agent must follow to bring such a claim. In this regard, it would be helpful for the regulations to stipulate that a withholding agent may not file a claim against the U.S. government in a foreign court but may file a claim in a U.S. federal court or make an administrative claim for indemnification with Treasury or the IRS under specified procedures.

We also recommend that for purposes of the indemnity, "any tax" should be defined to include any amount withheld on foreign passthru payments. This clarification is consistent with Section 1474(a), which indemnifies withholding agents against claims for "the amount of any payments made in accordance with" chapter 4, and not just against claims for the amount of withheld taxes paid in accordance with chapter 4. This clarification is also consistent with Section 1474(a), which defines foreign passthru payment withholding as a tax.

5. PFFIs should be provided with an alternative method of depositing withheld amounts.

The Proposed Regulations generally require all withholding agents to deposit withheld amounts with the IRS through the Electronic Federal Tax Payment System. As we noted in our report on Notice 2010-60,[206] this requirement poses certain challenges for FFIs that may need to

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[204] *See* I.R.C. § 1461; Treas. Reg. § 1.1461-1(e).

[205] *See* Harvey P. Dale, *Withholding Tax on Payments to Foreign Persons*, 36 TAX L. REV. 49, 96-99 (1980).

[206] New York State Bar Association Tax Section, *Report on IRS Notice 2010-60*, (Rep. No. 1224, Nov. 16, 2010).

transmit withheld taxes to the IRS. Many of these FFIs are not otherwise subject to the U.S. tax regime and may not have U.S. bank accounts or any bank accounts denominated in U.S. dollars. These entities may have difficulty both navigating through and complying with these payment rules.

The Proposed Regulations do not address the concerns we raised in our earlier report. We therefore reiterate our recommendation that Treasury consider alternative payment methods for amounts withheld by FFIs under chapter 4, including the possibility of allowing the transmission of amounts withheld through normal interbank payment mechanisms.

6. The principles of a hypothetical transaction under Treasury Regulation section 1.743-1(d) should apply in order to determine the amount of gross proceeds subject to FATCA withholding for partnerships and other flow through entities.

The Preamble requests comments on how a withholding agent that is a flow-through entity should allocate gross proceeds among its partners, beneficiaries or other owners, for purposes of withholding under FATCA.[207]

We believe the existing rules under subchapter K provide a useful framework for addressing this issue. In the event of an optional adjustment to basis of partnership property as a result of an election under Section 754 in connection with a taxable transfer of a partnership interest, the transferee's share of the adjusted basis of the partnership property is determined as if the partnership had sold all of its assets for cash equal to their fair market value immediately after the transfer. We believe that a similar framework might apply for purposes of determining the amount of gross proceeds subject to FATCA withholding with respect to each partner or beneficial owner when a partnership or other flow-through entity sells an asset of a type that can produce U.S. source interest or dividends.

Specifically, we recommend that a partnership or other flow-through entity be permitted to determine the share of gross proceeds allocable to each of its partners or other beneficial owners as follows:

First, after the sale of the asset in question, determine the amount of cash that the partner or beneficial owner would receive upon the hypothetical sale by the partnership or flow-through entity of all of its remaining assets at book value followed by a liquidation.

Second, determine the amount of cash that the foreign partner or beneficial owner would receive under the same construct, but assuming that the asset in question had been sold for zero consideration.

[207] Preamble at section XIX.F, 77 Fed. Reg. at 9041.

Third, subtract the amount arrived under the second step from the amount arrived under the first step and treat the difference as the gross amount allocable to each relevant partner or other equity owner for purposes of FATCA.

We believe this method of allocating the gross proceeds would best reflect how the relevant gain is economically allocated among the owners of a partnership or other flow-through entity.

7. The withholding procedures relating to payments of gross proceeds should conform to the withholding procedures for payments of U.S. source FDAP income.

Although the Proposed Regulations require withholding on both U.S. source FDAP income and gross proceeds from the sale of certain property, they provide different withholding mechanics for these two types of payments. We believe that this is likely to create unnecessary confusion for withholding agents and recommend that Treasury adopt a consistent procedure for both categories of payments.

When a withholding agent makes a U.S. source FDAP income payment to a PFFI that is a nonqualified intermediary, the Proposed Regulations require the withholding agent to look through the PFFI. The withholding is determined as if the payment had been made directly to the person or persons on whose behalf the PFFI is acting as an intermediary.[208] The same treatment applies to payments made to a qualified intermediary ("**QI**") that makes an election under Section 1471(b)(3) to not assume the responsibility for FATCA withholding.[209]

By comparison, when a withholding agent makes a payment of gross proceeds to a PFFI that is a nonqualified intermediary, there is no special rule under the Proposed Regulations that exempts the PFFI from the requirement to withhold on the gross proceeds and instead shifts the withholding burden to the person that pays the PFFI. Rather, the PFFI must withhold when it remits the gross proceeds to the persons on whose behalf it is acting as an intermediary. Furthermore, Proposed Regulations section 1.1471-2(a)(2)(iii) specifically provides that the Section 1471(b)(3) election is available only with respect to a payment of U.S. source FDAP income. As a result, a PFFI that is a QI cannot choose to allow the withholding agent that pays

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208 Prop. Reg. §§ 1.1471-2(a)(2)(i) and 1.1471-3(a)(3)(i)(A)(2). The same approach is adopted for payments to nonwithholding partnerships and nonwithholding trusts. Prop. Reg. §§ 1.1471-2(a)(2)(i) and 1.1471-3(a)(3)(ii)(A)(1).

Although the remainder of the discussion in the text of this recommendation 7 refers only to qualified intermediaries and nonqualified intermediaries, the same or similar rules also apply for withholding and nonwithholding partnerships and trusts.

209 Prop. Reg. §§ 1.1471-2(a)(2)(iii) and 1.1471-3(a)(3)(i)(A)(2).

gross proceeds to such QI to assume responsibility for FATCA withholding. Instead, the QI must withhold when it pays the gross proceeds to the persons on whose behalf it is acting.

It is not clear why the Proposed Regulations have rules governing the payment of gross proceeds that differ from the rules governing the payment of U.S. source FDAP income, and do not permit the election to be withheld upon under Section 1471(b)(3) to apply to gross proceeds. Section 1471(b)(3) by its terms does not limit this election to U.S. source FDAP income.

We believe that having two different withholding procedures, with one applicable to payments of U.S. source FDAP income and the other applicable payments of gross proceeds, is likely create confusion in the market. In addition, it does not appear that any of the purposes of FATCA would be frustrated, if the withholding procedures for gross proceeds were conformed to those that apply to payments of U.S. source FDAP income. Accordingly, we recommend that the withholding procedures for gross proceeds be so conformed (including by extending the Section 1471(b)(3) election so that it covers gross proceeds).

8. Final regulations should provide a refund of gross proceeds withholding to a nonparticipating FFI or passive NFFE that is eligible for the benefits of a tax treaty. Final regulations should also provide a refund of passthru payment withholding to a nonparticipating FFI that is eligible for the benefits of a treaty.

As described above, the Proposed Regulations generally permit a payee that is entitled to the benefits of a tax treaty to obtain a refund or credit for amounts that were withheld under chapter 4, even if the payee is a passive NFFE or a nonparticipating FFI. Most U.S. tax treaties reduce withholding on payments of U.S. source FDAP income to beneficial owners that are resident in the other contracting state and otherwise qualify under the treaty's "limitation on benefits" article. However, treaties do not address gross proceeds withholding.

The Joint Committee of Taxation suggested that gross proceeds withholding under chapter 4 should be refundable or creditable to a nonparticipating FFI or to a non-exempt NFFE that is entitled to the benefits of a tax treaty to the extent that the withholding would not have been required under any other provision of the Code.[210] Consistent with this suggestion, we recommend that final regulations expressly provide that a nonparticipating FFI or a passive NFFE that is entitled to a reduced rate of withholding under a treaty with respect to U.S. source

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[210] *See* J. COMM. ON TAX. REP. 60-09, at 135-36 ("In general, the determination of whether an overpayment of tax deducted and withheld under the provision results in an overpayment by the beneficial owner of the payment is made in the same manner as if the tax had been deducted and withheld under subchapter A of chapter 3 (withholding tax on nonresident aliens and foreign corporations). . . .[I]f a payment is of an amount not otherwise subject to U.S. tax (because, for instance, the payment represents gross proceeds from the sale of stock or is interest eligible for the portfolio interest exemption), the beneficial owner of the payment generally is eligible for a credit or refund of the full amount of the tax withheld.").

FDAP income paid on an instrument may obtain a refund or credit of chapter 4 taxes imposed with respect to gross proceeds from the disposition of that instrument. This approach would provide treaty beneficiaries with the same U.S. tax benefit available to them before the enactment of FATCA.[211]

In addition, final regulations should clarify that if a nonparticipating FFI is eligible for the benefit of a treaty, a nonparticipating FFI should be entitled to claim a refund of part or all of its share of any foreign passthru payment withholding tax. One simple way to achieve this objective would be to treat foreign passthru payments as "other income" for purposes of the relevant treaty. The specific clauses in most U.S. treaties that deal with dividends, interest, royalties, etc. normally would apply only to U.S. source payments, and a foreign passthru payment would have a foreign source; by comparison, the "other income" clause generally would state that all income of any source (U.S. or foreign) that is not specifically covered by other articles would be exempt from U.S. tax.[212] Alternatively, a more targeted way to extend treaty benefits to foreign passthru payments would be to treat the passthru payment regime as a re-sourcing rule. That is, the character of a passthru payment as a dividend, interest, etc. would be determined based on normal U.S. federal income tax principles applied to that payment and the pass-thru payment would be treated as having been re-sourced from foreign to U.S. source to the extent that such payment was subjected to U.S. withholding tax (for example, the passthru payment percentage of an interest payment would be treated as U.S. source interest). The appropriate article of the treaty would then govern the re-sourced payment, which would establish the applicable rate of U.S. withholding tax and therefore the amount of the refund.

VIII. Transition and Grandfathering Rules

A. Background

Section 501(d)(2) of the HIRE Act provides that no amount shall be required to be deducted or withheld from any payment under any obligation outstanding on March 18, 2012, or from the gross proceeds from any disposition of such an obligation. The Proposed Regulations extend the grandfathering date to January 1, 2013 and provide that a withholdable payment or passthru payment does not include any payment on an obligation outstanding on January 1, 2013 or any gross proceeds from any disposition of such an obligation.[213] The Proposed Regulations also clarify that the term "obligation" generally includes a debt instrument, a revolving credit facility, a letter of credit facility, a life insurance contract, a term certain annuity contract, and a

[211] In this connection, we note that U.S. tax treaties generally prohibit the United States from imposing tax on gains from a sale of property by a resident of a treaty partner. *See* U.S. Model Income Tax Convention, Art. 13(6) (2006).

[212] *See* U.S. Model Income Tax Convention, Art. 21 (2006).

[213] Prop. Reg. § 1.1471-2(b)(1).

derivative transaction entered into under an ISDA Master Agreement and evidenced by a confirmation.[214]

B. Summary of Recommendations

1. The extension of the grandfathering period to January 1, 2013 should be immediately adopted in a notice or other form of guidance on which taxpayers may rely.

2. Final regulations should clarify that debt issued on or after January 1, 2013 pursuant to a grandfathered obligation to extend credit is itself a grandfathered obligation.

3. Treasury and the IRS should determine whether debt issued in a qualified reopening of a pre-2013 original issuance will be grandfathered without any limit on when the qualified reopening takes place.

4. The "grandfathered obligation" rules should apply to withholdable payments and passthru payments by PFFIs.

5. The grandfather rule for foreign passthru payments should apply to obligations that are outstanding on December 31, 2015 (or, if later, a date that is 90 days after the issuance of proposed guidance on the definition of foreign passthru payment).

6. Grandfathered obligations not only should be exempt from FATCA withholding but also should be excluded from the definition of a "financial account".

7. Final regulations should provide that withholding agents are allowed to rely on the form of an instrument as debt in order to treat the instrument as an "obligation" for purposes of applying the grandfathering rule.

8. Final regulations should treat as grandfathered obligations certain self-amortizing equity of securitization vehicles issued prior to the enactment of the HIRE Act.

9. Major clearing systems and similar institutions should be treated as deemed-compliant FFIs at least on a transitional basis.

C. Discussion

1. The extension of the grandfathering period to January 1, 2013 should be immediately adopted in a notice or other form of a guidance on which taxpayers may rely.

We appreciate the government extending the grandfathering date and granting taxpayers additional time to prepare for this new reporting regime. We also appreciate and welcome the

[214] Prop. Reg. § 1.1471-2(b)(2)(ii).

broadened definition of the term "obligation" in this regard, which under the Proposed Regulations include not only a debt instrument but also a binding agreement to extend credit for a fixed term where the material terms are fixed as of the agreement's issue date (such as customary revolvers and letters of credit).

While the extension and the broad definition is a welcome relief, Proposed Regulations are not effective until finalized. This creates uncertainty regarding the status of obligations issued after March 18, 2012 and before January 2, 2013. We recommend that the IRS issue immediate guidance regarding the grandfathering rules described in the Proposed Regulations in a notice or other form on which taxpayers may rely.

2. Final regulations should clarify that debt issued on or after January 1, 2013 pursuant to a grandfathered obligation to extend credit is itself a grandfathered obligation.

As noted above, the Proposed Regulations define a grandfathered obligation to mean any obligation outstanding on January 1, 2013.[215] They also provide that for an obligation that is a debt instrument, the determination of whether the debt is grandfathered is determined based on its "issue date"; this contrasts with other types of obligations, which are treated as outstanding if they are the result of a legally binding agreement establishing the obligation that was executed prior to January 1, 2013.[216] "Issue date" is not defined in the Proposed Regulations, although the Preamble suggests this term should be given the same meaning it has under general U.S. tax principles, which normally look to the date when credit is actually extended and a debt instrument is issued by the borrower.[217]

It is not entirely clear how these rules apply to a debt instrument that is issued pursuant to a pre-existing binding agreement to extend credit, such as a line of credit or revolving credit facility. Based on the overall framework for the grandfather rules in the Proposed Regulations, we believe that such a debt instrument is intended to be treated as grandfathered, so long as the binding agreement to extend credit under which the debt instrument is issued has been entered into before January 1, 2013; this is so regardless of whether the debt instrument itself is not issued until after that date. Nevertheless, the Proposed Regulations can be read as literally providing that in the case of any debt instrument (including one issued pursuant to a pre-existing obligation to extend credit), the debt is considered for purposes of the grandfather rules to be outstanding from the debt's instrument's issue date, i.e., the date when the debt is issued by the

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215 Prop. Reg. § 1.1471-2(b)(2)(i).

216 Prop. Reg. § 1.1471-2(b)(2)(iii).

217 *See* Preamble, 77 Fed. Reg. at 9029 ("A debt instrument is outstanding on January 1, 2013, if it has an issue date, as determined under U.S. tax law, before January 1, 2013."); *see also* I.R.C. § 1275(a)(2) and Treas. Reg. § 1.1273-2.

borrower in exchange for an extension of credit.[218] In order to prevent this unintended result, we recommend that the IRS clarify that indebtedness issued pursuant to a binding commitment entered into during the grandfather period is itself treated as grandfathered.

3. Treasury and the IRS should determine whether debt issued in a qualified reopening of a pre-2013 original issuance will be grandfathered without any limit on when the qualified reopening takes place.

As discussed immediately above, the Proposed Regulations provide that a debt obligation is a grandfathered obligation if its issue date is prior to January 1, 2013. In regulations dealing with original issue discount (OID), the qualified reopening rules provide for situations in which newly issued debt obligations which would otherwise be part of a separate issuance from earlier debt instruments will instead have the same issue date (as well as issue price and adjusted issue price) as those earlier debt instruments.[219]

By focusing on a debt instrument's issue date (as determined under general tax principles), the Proposed Regulations literally permit indebtedness that is issued many years after an original issuance in 2012 or earlier to qualify for grandfathering relief. Under the qualified reopening regulations, new obligations issued with no more than a *de minimis* amount of OID will qualify as a reopening of an earlier issuance provided that the original debt instruments are publicly traded, even if the new issuance occurs several years after the original one.[220] We recommend that Treasury and the IRS determine whether allowing such latitude in the name of preserving the fungibility of newly-issued debt is consistent with the policies behind FATCA. If it is determined that it would be in keeping with FATCA's goals to impose limits on grandfather status for qualified reopenings, then final regulations could permit debt issued in a qualified reopening to be grandfathered only if the reopening occurs within, say, 12 months after the original issuance. In addition, to further limit opportunities for manipulation, a qualified reopening that attains grandfathered status could be limited to, say, 75% of the issue price of the debt issued in the original issuance (i.e., a percentage that we believe is toward the upper end of the normal range of sizes for a reopening).[221]

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[218] Under this narrow reading, the treatment of an agreement to extend credit as a grandfathered obligation could be viewed as exempting only payments made pursuant to the agreement itself (e.g., commitment or similar fees) from FATCA withholding, with each draw under such agreement treated as a separate and distinct "obligation". The status of each loan as a grandfathered obligation would then depend on that particular loan's issue date, not the date of the agreement to extend credit.

[219] Treas. Regs. §§ 1.1275-2(d)(2)(i), 1.1275-2(k)(1).

[220] *See* Treas. Reg. § 1.1275-2(k)(3)(iii).

[221] On the other hand, if Treasury and the IRS determine that preserving fungibility is a sufficiently important goal to warrant treating all debt issued in qualified reopenings of pre-2013 original issuances as grandfathered debt,

4. *The "grandfathered obligation" rules should apply to withholdable payments and passthru payments by PFFIs.*

Section 501(d)(2) of the HIRE Act exempts from withholding payments on, and proceeds from the disposition of certain grandfathered obligations outstanding on March 18, 2012. In Notice 2011-53, Treasury and the IRS stated they intended to issue regulations that would confirm that grandfathering applied both to obligations giving rise to withholdable payments, and obligations giving rise to passthru payments.

Proposed Regulations section 1.1471-2(b) excludes payments on, and proceeds from the disposition of "grandfathered obligations" from treatment as withholdable payments and passthru payments but does not purport to redefine "passthru payment" more generally. Proposed Regulations section 1.1471-2(b) extends the cut-off date for grandfathered treatment to January 1, 2013, defines "obligation" and defines what it means to be "outstanding" on the cut-off date. However, Proposed Regulations section 1.1471-2(b) states that these rules apply "solely for purposes of this paragraph (b)."

It technically is not entirely clear that the grandfathered obligation provisions of the Proposed Regulations apply to a PFFI that makes withholdable payments or passthru payments. Proposed Regulations section 1.1471-4(b) provides that a PFFI satisfies its withholding obligations under Sections 1471 and 1472 by complying with Proposed Regulations section 1.1471-4(b) and its FFI agreement. Proposed Regulations section 1.1471-4(b) also provides that a PFFI must deduct 30% of any passthru payments that are withholdable payments and currently reserves on foreign passthru payments. For this purpose, the general definitions of withholdable

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then they may also want to consider whether any special rules should be adopted to deal with debt issued in non-qualifying reopenings that is nevertheless fungible as a practical matter with a pre-2013 original issuance of debt.

Under certain circumstances, debt instruments are treated as fungible in the market even though they may technically not be treated as part of the same issue under the qualified reopening rules. This is typically the case when original debt instruments and additional debt instruments are issued under the same indenture with the same terms, including the same fixed or variable interest rate payable in cash throughout the term of the instruments, and are issued without any OID or any special feature that causes the debt instrument to be treated as a contingent payment debt instrument. In such a case, both the original and the additional debt instruments are subject to the same tax treatment in the hands of the holders thereof, and thus are typically treated fungible in the market (that is, they are given the identical CUSIP/ISIN). While the terms are identical and there is no OID, the issuance of the additional bonds in such a case may nevertheless not meet the definition of a qualified reopening due to the lack of pubic trading of the debt instruments (or qualified reopening status may be ambiguous due to uncertainty as to whether there is public trading of the debt). We note that due to FATCA, the additional debt that is issued might not be treated as fungible as a practical matter with the originally issued debt, if the original issuance takes place before January 1, 2013 and the additional debt is issued afterward, because the additional debt would not be treated as grandfathered. Depending on their views about the importance of preserving fungibility, Treasury and the IRS might consider adopting a rule under which debt instruments that are not issued in a qualified reopening but nevertheless are fungible as a practical matter with debt originally issued before 2013 will be treated as grandfathered.

payment and passthru payment presumably apply. However, it is not clear that the exclusion from withholdable payment and passthru payment treatment for grandfathered obligation payments in Proposed Regulations section 1.1471-2(b) is incorporated, as the latter provision merely excludes grandfathered obligations without purporting to redefine "withholdable payment" and "passthru payment" more generally.

It does not appear that Treasury and the IRS have decided to change the position they expressed in Notice 2011-53 regarding application of the grandfather rules to obligations that give rise to withholdable payments or passthru payments. We believe the best reading of the Proposed Regulations as drafted is that the grandfathering rules were intended to be imported into Proposed Regulations section 1.1471-4(b).[222] Nevertheless, we recommend that final regulations confirm this interpretation.

5. The grandfather rule for foreign passthru payments should apply to obligations that are outstanding on December 31, 2015 (or, if later, a date that is 90 days after the issuance of proposed guidance on the definition of foreign passthru payment).

For the reasons described above, we recommend that final regulations clarify that any future definition of foreign passthru payment exclude payments on grandfathered obligations. In addition, we suggest that solely for this purpose, regulations extend the cut-off date for grandfathered obligations. Although foreign passthru payments will not be subject to withholding until 2017, this does not resolve the uncertainty for issuers who issue obligations after 2012 that provide for payments after 2016 and, thus, may give rise to foreign passthru payments.

For example, Proposed Regulations section 1.1471-2(b)(ii) provides that a derivative transaction entered into between counterparties under an ISDA Master Agreement together with a confirmation will be an obligation for purposes of the grandfathered obligation rule. Such derivatives evidenced by an ISDA Master Agreement and confirmation and other obligations that are issued before January 1, 2013 will be exempt from FATCA withholding. However, derivatives and other obligations issued on or after this date may be subject to withholding under FATCA if a foreign passthru payment is made to a nonparticipating FFI or recalcitrant account holder after 2016.

Similarly, a PFFI that issues debt after 2012 will be concerned that the interest payments on the debt after 2016 may be treated as foreign passthru payments under final regulations and that withholding may be required if the PFFI is unable to obtain information regarding the ultimate beneficial owners (a practical impossibility if it issues the debt through a foreign clearing system and that clearing system does not become a PFFI). As discussed further in Part

[222] *See* Prop. Reg. § 1.1471-4(a).

IV.C above, debt issued by most FFIs other than Investment FFIs is excepted from treatment as a "financial account" and thus, in our view, should not be subject to withholding by a PFFI under Section 1471(b). However, this does not address the problem for all issuers: there are substantial amounts of debt issued by securitization vehicles and by other Investment FFIs whose debt will constitute a financial account.

A four year lag between the current cut-off date of the grandfathered obligation rule and the anticipated effective date of withholding on foreign passthru payments places a significant burden on PFFIs and other counterparties to divine the probable contours of the foreign passthru payment rules. We therefore recommend the grandfathered obligation cutoff date be extended, solely for purposes of foreign passthru payment withholding, to obligations outstanding on December 31, 2015 or, if later, a date that is 90 days from the issuance of proposed guidance on the meaning of foreign passthru payment. (A further extension can always be considered at the time such proposed guidance is issued if the content of final guidance defining foreign passthru payments remains substantially uncertain given the nature of the proposed guidance.)

6. Grandfathered obligations not only should be exempt from FATCA withholding but also should be excluded from the definition of a "financial account".

Proposed Regulations section 1.1471-2(b) provides that "[n]otwithstanding §§1.1471-5(h) and 1.1273-1(a), a withholdable payment or passthru payment does not include any payment made under a grandfathered obligation or any gross proceeds from the disposition of such an obligation." While thus excluded from FATCA withholding, there is no provision in the Code or the Proposed Regulations that excludes grandfathered obligations from the definition of "financial account."

When a withholding agent that is not a PFFI makes a payment on a grandfathered obligation, no withholding obligation generally means no need to determine the identity of the recipient of the payment under the FATCA rules. The grandfathered obligation would fall outside of the FATCA regime. However, for PFFIs, collecting and reporting information regarding financial accounts is a separate and distinct obligation. Thus, although a PFFI will not be required to withhold on payments made on a grandfathered obligation, the PFFI will still be required to collect information about the holder of that obligation and to report the information to the IRS, if such obligation is a financial account. Yet there would be no incentive for holders of such financial accounts (which constitute grandfathered obligations) to cooperate in providing information to the PFFI, since there would be no withholding on payments on such accounts. As a result, the PFFIs might be left in a difficult position of having to collect information and report on such financial accounts when there are no practical means to enforce such collection.

We believe that FATCA withholding and FATCA information reporting should go hand in hand. A fundamental principle underlying the FATCA withholding regime is that foreign recipients of U.S. source payments must either provide information regarding U.S. ownership or U.S. accounts or suffer FATCA withholding. We believe that when Congress excluded grandfathered obligations from FATCA withholding, they meant to exclude them entirely. Treating grandfathered obligations as financial accounts and requiring collection of the same information as required for non-grandfathered obligations would impose a difficult burden for PFFIs that we believe is beyond what Congress intended. Therefore, we recommend that Treasury and the IRS provide that the grandfathered obligations are excluded from the definition of "financial account".

7. Final regulations should provide that withholding agents are allowed to rely on the form of an instrument as debt in order to treat the instrument as an "obligation" for purposes of applying the grandfathering rule.

The Proposed Regulations provide that while the term "obligation" means any agreement that produces a passthru payment, it does not include any instrument that is treated as equity for U.S. tax purposes. Whether an instrument is debt or equity is an inherently factual question and is often not free from doubt.

In order to facilitate easy administration of the FATCA withholding, we recommend that final regulations provide that withholding agents may rely on the form of an instrument as debt to treat the instrument as an "obligation" for purposes of applying the grandfathering rule unless there is a clear statement in the governing documents, offering documents or other available disclosure documents that the instrument is (or should be) treated as equity (or something other than an "obligation" for federal income tax purposes). In this connection, we recommend that a withholding agent generally should not be required to obtain, or seek to obtain, documents not in its possession for purposes of determining whether such a statement exists, except perhaps for an offering document filed with the U.S. Securities and Exchange Commission (or similar foreign agency that makes filings readily available to the public). In addition, we suggest that a withholding agent should be entitled to rely on a written representation by the issuer of an instrument as to whether any documents exist stating that the instrument is other than debt for U.S. federal income tax purposes.[223]

8. Final regulations should treat as grandfathered obligations certain self-amortizing equity of securitization vehicles issued prior to the enactment of the HIRE Act.

In the Preamble, comments are requested regarding whether equity interests in a securitization vehicle should be treated as grandfathered obligations, if the vehicle invests solely

[223] Because perpetual debt is generally treated as stock for U.S. federal income tax purposes, the right to rely on the form of an instrument as debt should not apply to such instruments. Instead, a withholding agent should be required to treat the instrument as stock under these rules unless the issuer provides an opinion of a qualified tax advisor supporting its treatment as debt for U.S. federal income tax purposes.

in debt and similar instruments and will liquidate within a specified timeframe, given the types of investments the vehicle holds and the extent of the vehicle's reinvestment of other assets. The Preamble further requests comments about limits on such grandfathered treatment to avoid abuse.[224]

Securitization vehicles typically provide for some type of amortization provisions. For an issuer of collateralized debt obligations or collateralized loan obligations, a customary self amortization provision would include a 3 to 7-year reinvestment period during which the issuer would be permitted, subject to satisfaction of certain performance tests and other criteria, to reinvest principal proceeds from its assets in certain categories of permitted assets (which are mostly debt securities), after which principal proceeds received from its assets could be either distributed pursuant to the waterfall or, in certain limited circumstances, reinvested in permitted assets until the maturity date of the securities issued by the issuer. Other securitization vehicles often do not include any reinvestment period at all, although some securitization vehicles may have a longer term reinvestment period. In the case of securitization vehicles established before the HIRE Act, the assets of these vehicles will consist mostly of grandfathered obligations, with reinvestment periods likely to expire over a short time horizon. As a result, the equity interests in such vehicles represent mostly ownership of the residual interest in grandfathered obligations.

Therefore, we believe it is reasonable to extend grandfathering to equity instruments issued by a securitization vehicle where the manager provides a written certification that (i) the securitization vehicle was established prior to March 18, 2010, (ii) more than (say) 80% of the assets of the securitization vehicle consist of grandfathered obligations and (iii) the vehicle has a remaining reinvestment period that will end by (say) the seventh anniversary of FATCA's enactment. We believe that a rule permitting a withholding agent to rely on a written certificate from the manager of a securitization vehicle to this effect makes sense, as otherwise the withholding agent would not be able to establish the asset composition of the securitization vehicle. In our view, the approach that we have just described is appropriately tailored to further the purposes of the grandfather rules, without providing any meaningful opportunity for abuse.

9. Major clearing systems and similar institutions should be treated as deemed-compliant FFIs, at least on a transitional basis.

In view of the unique role played by clearing systems in the global capital markets, we believe it is appropriate to consider providing special transitional rules tailored specifically to them, including for purposes of PFFI withholding and reporting. Clearing systems generally take title to securities (typically, to a global security evidencing an entire issue) directly or through another custodial institution. The clearing system maintains book entry accounts on behalf of a small number of primary participants that are major global money center banks or similar institutions. These in turn create book entry account interests for their customers,

[224] *See* Preamble at section XIX.G, 77 Fed. Reg. at 9041.

including other financial intermediary institutions, and so on. The ultimate investor holds a book entry interest in the security, generally through multiple layers of financial institutions acting in an intermediary capacity.

Technically, a clearing system itself only qualifies as a financial institution under the rubric of "holding financial assets for the account of others" pursuant to Proposed Regulations section 1.1471-5(e)(1)(ii). It is questionable whether clearing systems really engage in the kinds of custodial activities on behalf of clients that are within the intended scope of this language. However, even if they are properly considered financial institutions, it is not clear that the general approach under FATCA should apply to them in the same manner as to other financial institutions. Under Proposed Regulations section 1.1471-3(a)(1) and (2), it appears that a foreign clearing system would be considered a "payee" subject to withholding on withholdable payments and foreign passthru payments that it receives unless it becomes a PFFI, even though it is questionable whether such treatment is appropriate.[225]

Given that most publicly traded and highly-liquid securities today are issued through clearing systems in book entry form, we believe clearing systems pose a dilemma. On the one hand, permitting issuers to make payments through clearing systems without imposing any conditions or requirements would effectively exempt a very substantial portion of the securities market from FATCA. On the other hand, in stark contrast to other types of financial institutions, these institutions are in the business of disintermediation rather than intermediation. Unlike regular financial institutions, they do not have "customer" and "client" relationships. This greatly limits the incentives and opportunities for clearing systems to collude with individual U.S. account holders to create offshore accounts. As a practical matter, the direct participants in a clearing system or exchange, for example, are all major global financial institutions that already have ample incentives to become PFFIs and police the sub-institutions and investors in the chain of custody and conduct the diligence and reporting envisioned by FATCA.

Moreover, we do not think that market forces necessarily will ensure capital markets can continue to function if some accommodation is not reached with clearing systems. In the case of other kinds of financial institutions, it seems reasonable to assume that the market will gravitate to PFFI institutions, both allowing the capital markets to function while creating incentives for FFIs to become PFFIs. That is less clear in the case of clearing systems. Because clearing systems operate in certain respects as natural near-monopolies, there are only a small number of such systems and there is limited competition. Issuers, investors and other intermediaries that

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[225] Under Proposed Regulations section 1.1471-5(a)(3)(iii), a foreign clearing system also would qualify as an "account holder."

Similarly, a U.S. clearing system would appear to be a "payee," assuming the paying agent has no reason to know that the clearing system will not comply with its withholding obligations under Sections 1471 and 1472. *See* Prop. Reg. § 1.1471-3(a)(3)(iii). It would also be an account holder. *See* Prop. Reg. § 1.1471-5(a)(3)(iii).

interact with clearing systems have far more limited opportunities for self help if clearing systems fail to become compliant. Issuers confront particular uncertainty because payments they make on certain securities issued currently may later become subject to FATCA withholding after the applicable transition period expires.[226] Issuers cannot assume they will be able to migrate a security to a different clearing system in that event, as an account holder might move its custodial account at a nonparticipating FFI to a competing PFFI. Yet, there is no practical way for a securities issuer facing a clearing system to determine the beneficial owner of securities without the cooperation of the system and its participating institutions.

Given the special position of clearing systems in the international capital markets, we suggest that at least for some transitional period, clearing systems should be considered deemed-compliant FFIs. This transitional period could last, for example, until the conclusion of successful negotiation of an FFI agreement between the IRS and at least one foreign clearing system. It should be noted that during the transitional period, payments made through clearing systems would not cease to be subject to FATCA withholding and reporting; rather, the effect would simply be to move the withholding and reporting burden to the financial institutions that are members of the clearing system. FFIs and U.S. financial institutions that are members would be withholding agents, and thus would be required to comply with the FATCA withholding and reporting rules.[227]

After the end of the transitional period, it may be appropriate to permit clearing systems to be deemed to be withholding QIs provided that (as is likely) all of the primary participants in the clearing system are withholding QIs.

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[226] This transitional uncertainty would be relieved substantially if our proposals in Part IV.C.7 to require withholding on pass-thru payments only with respect to financial accounts is adopted. As the Proposed Regulations are currently drafted, however, even if a security issued by a PFFI is publicly traded, unless it is grandfathered debt, the PFFI might be required to withhold on payments to nonparticipating FFIs. Accordingly, after 2012 (or after 2015, if our recommendation 5 above is accepted), a PFFI must issue securities through a clearing system without knowing or controlling whether FATCA withholding will in future apply or whether it will be able to comply with its reporting obligations.

[227] As an alternative to this recommendation, Treasury and the IRS could consider treating a clearing system as a nonwithholding intermediary, which would allow each issuer of securities to "look through" the clearing system and withhold on the basis of the chapter 4 status of each of the underlying clearing system members. However, we believe this alternative approach would present far greater compliance burdens than the approach described above. For example, a “look through” approach would require an issuer to obtain a new list of every member of the clearing system that holds the issuer's securities on each interest or dividend payment date.

Appendix