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Next Phase of FATCA Guidance Arrives with Proposed Regulations and Announcement of Possible Intergovernmental Approach

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On February 8, 2012, the US Treasury Department (“US Treasury”) and the Internal Revenue Service (“IRS”) released long-awaited proposed regulations on the Foreign Account Tax Compliance Act (“FATCA”).¹ The proposed regulations provide further guidance on many topics, including the steps that foreign financial institutions (“FFIs”) will need to take to ensure that they identify their US accounts and report information about these US accounts to the IRS each year. These rules are enforced by a 30% withholding tax on US-source payments to FFIs that fail to comply, although the proposed regulations phase this withholding tax in over the next few years. On the same day, the US Treasury and the governments of France, Germany, Italy, Spain and the United Kingdom released a joint statement – the negotiation of which likely caused the delay in the issuance of the proposed regulations – on a possible intergovernmental approach to the implementation of FATCA and improving international tax compliance. Under this framework, each foreign government would collect FATCA information from its own financial institutions and then transfer that information automatically to the United States each year and the United States would reciprocate by collecting and sharing information about non-US accounts at US financial institutions.

This alert provides an overview of the changes to prior FATCA guidance in the proposed regulations, with a focus on the issues for investment funds. The key developments in the proposed regulations, which are discussed in more detail below, are as follows:

- *Definition of FFI and financial account.* The definition of FFI now includes any insurance company that issues insurance contracts with an investment component (and those contracts are now included in the term “financial accounts”).
- *Due diligence requirements to identify US accounts.* FFIs must generally apply a series of filters to their accounts to identify those with enough indicia of US ownership to warrant gathering further information. FFIs may generally rely on electronic searches of preexisting individual accounts, with enhanced review of accounts over \$1 million.
- *Procedures to verify compliance.* A responsible officer of the FFI must certify to the IRS that the FFI has complied with the FFI agreement (which is described in more detail below).
- *Phase-in of information required to be reported.* For reporting in 2014 and 2015 (with respect to calendar years 2013 and 2014), FFIs will be required to report only the name, address, taxpayer

¹ FATCA, originally proposed as stand-alone legislation, was enacted on March 18, 2010, as part of the Hiring Incentives to Restore Employment Act of 2010 (“HIRE Act”). This alert adopts the convention of using “FATCA” to refer to the withholding and information reporting provisions added as Sections 1471-1474, Chapter 4 of Subtitle A of the Internal Revenue Code of 1986, as amended (“Code”). In fact, the FATCA title of the HIRE Act also contains information reporting provisions with respect to foreign accounts (for our alert on regulations implementing these provisions, [click here](#)) and foreign trusts and provisions treating certain swap payments as US-source dividends subject to withholding.

identification number, and account balance with respect to US accounts. Reporting on income will be added in 2016 (with respect to 2015) and reporting on gross proceeds will begin in 2017 (with respect to 2016).

- *Passthru Payments.* Withholding on foreign passthru payments will be delayed until at least January 1, 2017. FFIs will be required to report annually on the aggregate amounts of certain payments to each nonparticipating FFI for the 2015 and 2016 calendar years.
- *New categories of entities that are deemed to comply with FATCA.* The proposed regulations create new deemed-compliant categories for certain qualified investment vehicles and restricted funds. These categories, however, are limited and still require due diligence and registration with the IRS.
- *Temporary relief for FFIs with non-compliant affiliates.* The requirements of an FFI agreement must generally apply to US accounts of the participating FFI and each other FFI that is a member of the same expanded affiliated group.² Until January 1, 2016, an FFI affiliate in a jurisdiction that prohibits the reporting and withholding required under FATCA will not prevent other FFIs in the same expanded affiliated group from entering into FFI agreements.
- *Expanded scope of grandfathered obligations.* Payments on, and gross proceeds from the disposition of, obligations outstanding on January 1, 2013 (rather than March 18, 2012, as provided in the legislation) will be exempt from FATCA withholding.
- *Proposed intergovernmental approach.* Five European governments may enter into agreements with the United States to collect information from their own FFIs and share that information with the United States, rather than having those FFIs enter into FFI agreements with the IRS.

I. FATCA Background and Framework

FATCA grew out of Congressional concern that US taxpayers were evading taxes by failing to report income on assets held abroad. FATCA attempts to compel FFIs to help curb US tax evasion by imposing a 30% withholding tax on “withholdable payments” to them if they fail to obtain and report information about their “US accounts” annually to the IRS. Non-financial foreign entities (“NFFEs”) must also report information about their substantial United States owners – generally certain US persons owning a greater than 10% equity interest, by vote or value – to any withholding agent or face this withholding tax. Withholding will begin in 2014 for withholdable payment consisting of US-source payments of interest, dividends and other similar passive income (referred to generally as “fixed and determinable annual or periodical” or “FDAP” income) and in 2015 for gross proceeds from the disposition of assets that produce US-source dividends and interest.³ The intergovernmental approach highlights that US Treasury’s primary purpose for FATCA is closing the tax gap by gathering information about US taxpayers with income and assets abroad. The withholding tax is primarily a mechanism to compel FFIs and NFFEs, which are generally not otherwise subject to US jurisdiction, to cooperate in this regard, rather than a revenue source in its own right.

² In general, an “expanded affiliated group” means a group of corporations where a common parent directly owns more than 50% of the stock (by vote or value) in at least one of the other corporations and that portion of the stock of each other corporation in the group is owned directly by one or more of the other corporations. A partnership will also be included if members of the group own more than 50% of the interests in the partnership (by vote or value).

³ The proposed regulations confirm this phased implementation schedule first set forth in IRS Notice 2011-53, 2011-32 IRS 124. As discussed below, however, withholding on foreign passthru payments has been delayed until at least January 1, 2017.

The FATCA legislation left many of the details on implementation to US Treasury and the IRS. The proposed regulations build on guidance set forth in three IRS notices.⁴

An FFI is defined in the Code as any:

- *Bank* – foreign institution that accepts deposits in the ordinary course of a banking or similar business,
- *Broker or Custodian* – foreign institution that, as a substantial part of its business, holds financial assets for the account of others, or
- *Investment Vehicle* – foreign institution that is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, notional principal contracts, commodities or any interest therein.

The second FFI category includes a typical brokerage firm. The third FFI category includes hedge funds, funds-of-funds, other private funds, and certain trusts. These FFI categories are sometimes referred to below using these shorthand designations (such as “investment vehicle” for FFIs in the third category).

The proposed regulations add any:

- *Insurance Company* – insurance company that issues or is obligated to make payments with respect to cash value insurance contracts and annuity contracts (that is, insurance contracts that include an investment component).

The information-sharing agreement that the FFI enters into with the IRS is called an “FFI agreement.” US Treasury and the IRS did not release a draft FFI agreement with the proposed regulations, but plan to do so within the next few months. An FFI that enters into such an agreement becomes a “participating FFI” or “PFFI” and will be issued an FFI-EIN for identification purposes. The FFI agreement will contractually require an FFI to identify and provide information to the IRS about its US accounts. If foreign law would prevent the FFI from reporting information on a US account, the FFI is required to attempt to obtain a valid and effective waiver of that law from the account holder or, if such a waiver cannot be obtained within a reasonable period of time, to close the account

A “US account” is any “financial account” held by one or more “specified United States persons” or “United States owned foreign entities.” A financial account is defined to correspond to the four types of FFIs listed above – a depository account, custodial account, any debt or equity interest in an FFI (other than interests that are regularly traded on an established securities market), and any cash value insurance contract or annuity contract. The reference to debt or equity interests in an FFI is intended to capture interests in investment vehicles. The proposed regulations make clear that debt and equity interests in the other types of FFIs – banks, brokers, custodians, and insurance companies – are only included if the value of the debt or equity interest is determined, directly or indirectly, primarily by reference to assets that give rise to withholdable payments.

A “specified United States person” is essentially any US person, other than publicly traded corporations, their affiliates, tax-exempt organizations, governments, banks, real estate investment trusts, regulated investment companies, and common trust funds. A “United States owned foreign entity” is a foreign entity with one or more “substantial United States owners,” generally defined as a specified United States person that is an owner of a greater than 10% interest, by vote or value. If the

⁴ Notice 2010-60, 2010-37 IRS 329; Notice 2011-34, 2011-19 IRB 765; and Notice 2011-53, 2011-32 IRS 124, are sometimes referred to below as the “FATCA Notices.”

foreign entity is an investment vehicle, however, any US owner is treated as a substantial United States owner, regardless of the 10% threshold.

The first category of withholdable payment, for FDAP income, is broader than the similarly defined category that is currently subject to withholding when paid to non-US persons, because FATCA does not reflect the exclusion for portfolio interest and limits the reduction in withholding taxes provided under tax treaties. The second category of withholdable payment, for gross proceeds, has no analog under prior law and reaches payments to a non-US person even when property is sold at a loss.

An NFFE is any foreign institution that is not an FFI. NFFEs must report information about their substantial United States owners to any withholding agent or FFI to avoid withholding tax.

II. Due Diligence Required to Identify US Accounts

The fundamental challenge for US Treasury and the IRS in designing the due diligence requirements has been to force FFIs to dig deep enough to identify any US accounts without adding too onerous a US tax overlay to account-opening procedures that are already governed by local law anti-money laundering (“AML”), know-your customer (“KYC”) and other requirements. The proposed regulations attempt to strike the proper balance by requiring FFIs to apply a series of filters to their accounts to identify those that are clearly US accounts and those with enough indicia of US ownership to require the FFIs to gather more information. In general, the proposed regulations build on the approach outlined in the FATCA Notices, setting forth separate rules for preexisting accounts and new accounts and for individual accounts and entity accounts. Entity accounts, in particular, pose a challenge because an FFI’s existing account opening procedures may not identify the substantial US owners that would cause a foreign entity to be a US-owned foreign entity.⁵

For a participating FFI, a preexisting account is an account, instrument or contract maintained or executed by the FFI prior to the date that the FFI agreement becomes effective.⁶ Notice 2011-34 provides that FFI agreements will be effective no earlier than July 1, 2013. Thus, for FFIs that become participating FFIs as early as possible, preexisting accounts will be those opened before July 1, 2013. One open question under the regulations is whether an addition to a preexisting account, particularly if for a different type of investment, will be treated as a new account or as part of the preexisting account.

A. Entity Accounts

For entity accounts, an FFI generally has two years from the effective date of its FFI agreement – until July 1, 2015, in the case of an FFI entering into its agreement as early as possible – to perform the identification procedures and collect the required documentation as set forth in the regulations. However, this is shortened to one year – until July 1, 2014 – for any account holder that is a foreign entity with a standardized industry code recorded in the FFI’s electronically searchable information indicating it is a financial institution (referred to as a “prima facie FFI”). Overriding both of these requirements is an exception (which an FFI may elect not to apply) for preexisting entity accounts with a balance of \$250,000 or less. The FFI must aggregate all entity accounts that are maintained by

⁵ As noted above, a “US account” includes an account owned by a US-owned foreign entity, which is a foreign entity with one or more substantial United States owners. A “substantial United States owner” generally means a specified United States person owning a greater than 10% interest, by vote or value, but in the case of an investment vehicle means any specified United States person.

⁶ For a withholding agent, a preexisting obligation means any account, instrument or contract maintained or executed by the withholding agent as of January 1, 2013. The discussion above focuses on the due diligence requirements for FFIs rather than the quite similar requirements for withholding agents.

the FFI or members of its expanded affiliated group (for example, a company's bank accounts at two affiliate banks), to the extent the accounts are linked in the FFI's computerized systems, as well as all accounts (including accounts held by individuals) that a relationship manager knows or has reason to know are directly or indirectly owned, controlled or established by the same person.

The proposed regulations provide considerable detail on the documentation required to identify an account holder's treatment for purposes of FATCA withholding (referred to in the regulations as its "chapter 4 status"). Examples of an account holder's chapter 4 status include its status as a PFFI, non-participating FFI, exempt beneficial owner,⁷ or NFFE. Many of these categories contain transition rules and exceptions. For example, for payments made before January 1, 2017, with respect to preexisting accounts, an FFI may treat an account holder as a participating FFI if the FFI has a Form W-8 (not updated for FATCA) indicating that the account holder is foreign, the account holder provides its FFI-EIN orally or in writing, and the FFI verifies that number in the FFI directory to be maintained by the IRS. Other categories provide exceptions for offshore obligations and preexisting offshore obligations that allow the FFI to rely on statements from the account holder or other information to determine the account holder's status. Many categories permit the FFI to rely on documentation collected for AML due diligence purposes.

The proposed regulations create a new category for passive NFFEs and generally require an FFI to obtain a written certification from each passive NFFE within two years of the effective date of the FFI agreement (the time frame noted above) either that the passive NFFE does not have any substantial US owners or providing the name, address and taxpayer identification number of each substantial US owner. For preexisting accounts with a balance or value of \$1 million or less, the FFI may rely on AML due diligence materials, rather than obtaining the written certification, to identify any substantial US owners.⁸ A passive NFFE is essentially a foreign entity with significant investment income such as dividends and interest and assets that produce or are held for the production of investment income, but not enough to cause it to be an investment vehicle FFI.⁹ The proposed regulations contain special rules for determining whether payments made before January 1, 2017, or payments with respect to offshore accounts or preexisting offshore accounts, are made to a passive NFFE or active NFFE, but these tests do not appear to affect the requirement that a passive NFFE with an account balance or value greater than \$1 million must provide a withholding certificate within two years of the FFI agreement's effective date in order to avoid withholding.

⁷ "Exempt beneficial owners" are foreign governments, political subdivisions of a foreign government, and wholly owned instrumentalities and agencies of a foreign government; international organizations and wholly owned agencies or instrumentalities of an international organization; foreign central banks of issue; governments of United States possessions; certain foreign retirement plans; and certain entities wholly owned by one or more other exempt beneficial owners.

⁸ On March 7, 2012, while speaking at an International Tax Committee meeting of the District of Columbia Bar Taxation Section, an IRS official stated that the IRS will soon make several substantive clarifications to the proposed regulations, revising the date for determining account value thresholds from the end of the prior year to the day the threshold amounts are determined.

⁹ More precisely, a passive NFFE is any NFFE that is not an active NFFE or another type of excepted NFFE, such as a publicly traded corporation, affiliate of a publicly traded corporation, or exempt beneficial owner such as a foreign government. An NFFE is an active NFFE if less than 50% of its gross income for the preceding calendar year is passive income and less than 50% of the assets held by the NFFE at any time during the preceding calendar year are assets that produce or are held for the production of passive income. The test for a passive NFFE thus ends up looking quite similar to the test for "passive foreign investment company" status. It should be noted that the proposed regulations now state that an NFFE will be considered active if the NFFE meets the active income requirement "or" the active asset requirement, while the Notice of Proposed Rulemaking to the proposed regulations states that an NFFE will be considered active if the NFFE meets the active income requirement "and" the active asset requirement. As indicated in note 8 above, the IRS will soon make several substantive clarifications to the proposed regulations, including clarifying that the definition of an active NFFE requires that an active NFFE meet the active income and the active asset requirement.

The proposed regulations, like the current regulations for withholding on payments of US-source FDAP income (such as dividends and interest) to non-US persons, contain presumptions for determining the chapter 4 status of a payee when no documentation is provided.

B. Individual Accounts

For preexisting accounts, the proposed regulations permit an FFI to conduct an electronic search to identify any accounts with “US indicia.” An account has US indicia if the information required to be reviewed with respect to the account includes any of the following: (1) identification of the account holder as a US resident or citizen; (2) US place of birth; (3) US resident address or US mailing address (including a US post office box); (4) US telephone number; (5) standing instructions to transfer funds to an account maintained in the United States; (6) power of attorney or signatory authority granted to a person with a US address; or (7) an “in-care-of” address or “hold mail” address that is the sole address the FFI has identified for the account holder. For these preexisting accounts, a participating FFI will not be attributed knowledge with respect to information contained in any account files that the participating FFI did not review and was not required to review. In general, unless an FFI elects otherwise, no review is required for preexisting accounts with a balance of \$50,000 or less, or \$250,000 or less in the case of preexisting cash value insurance or annuity contracts. Certain aggregation rules apply for this purpose. In addition, accounts will be subject to further due diligence procedures if the account balance or value later exceeds \$1 million.

For new accounts, the proposed regulations generally permit an FFI to rely on its existing account opening procedures and require additional review when the initial review indicates that the account has “US indicia” or with high-value accounts. For both preexisting and new accounts, when US indicia are present, the FFI must obtain additional documentation as specified in the regulations, such as a Form W-9 (if the account holder is indeed a US person) or Form W-8BEN and non-US passport or other government-issued identification evidencing citizenship in a country other than the United States.

The proposed regulations reject the enhanced review of private banking accounts set forth in Notice 2011-34 in favor of enhanced review of high-value accounts, defined generally as accounts with a balance in excess of \$1 million. This enhanced review requires an examination of both paper and electronic files, although paper review is limited to certain documents specified in the regulations. In addition, for high-value accounts for which a relationship manager has actual knowledge that the account holder is a US person, the participating FFI must obtain a Form W-9 and a valid and effective waiver, if necessary. A relationship manager is defined as an officer or other employee of an FFI who is assigned responsibility for specific account holders on an ongoing basis (including as an officer or employee that is a member of an FFI’s private banking department), advises account holders regarding their banking, investment, trust, fiduciary, estate planning, or philanthropic needs, and recommends, makes referrals to, or arranges for the provision of financial products, services, or other assistance by internal or external providers to meet those needs.

III. Verification Procedures

FATCA requires a participating FFI to comply with verification procedures established by US Treasury to certify that the FFI has complied with the terms of the FFI agreement. Unlike the qualified intermediary program, no third-party audits are required. The FFI agreement will specify the IRS’s verification process for determining compliance and will require the participating FFI to (a) adopt written policies and procedures to ensure compliance with the agreement, (b) conduct

periodic internal reviews for compliance, and (c) periodically submit to the IRS a certification and other applicable information that will demonstrate whether the FFI is FATCA-compliant.

The regulations state that a responsible officer of the FFI must provide the certification to the IRS. However, IRS officials have since stated that FFIs will have flexibility in designating officials to make the certification. The IRS believes it is best to leave the choice to the discretion of the FFI as to who is the official at a high enough level in the organization, with the proper level of responsibility over the FATCA-type functions, to certify compliance.

As discussed below, the regulations allow a registered deemed-compliant FFI to use one or more agents to perform necessary due diligence and to obtain and maintain deemed-compliant status. However, the FFI remains ultimately responsible for ensuring the requirements have been met. It is unclear whether participating FFIs will be afforded the same opportunity to use outside agents to make their certifications.

Failure to establish compliance may result in enhanced review procedures, including an external audit. The FFI agreement will not require prearranged, periodic audits, nor will it require external audits on a random basis. The FFI agreement will describe the circumstances under which a participating FFI would be considered to be in default; the regulations anticipate a fairly high threshold involving more than limited circumstances when there has been substantial noncompliance.

US Treasury and the IRS have specifically requested comments regarding the scope and content of the FATCA reviews and the data to be supplied with the certification. A draft FFI agreement is anticipated to be issued within the next few months, and may include general standards for the certification reviews.

IV. Deemed-Compliant Entities

The FATCA legislation authorized US Treasury to identify categories of FFIs that would be “deemed” to meet the FATCA requirements because they have no US accounts or otherwise pose a low risk of US tax evasion. It was anticipated that these types of FFIs would be subject to relaxed FATCA reporting burdens and be exempt from FATCA withholding.

The proposed regulations offer two tiers of “deemed-compliant” FFIs – registered and certified. A registered deemed-compliant FFI must register with the IRS declaring its status as deemed-compliant and attest to the IRS that it satisfies certain procedural requirements. A certified deemed-compliant FFI is not required to register with the IRS, but must certify to withholding agents on a Form W-8 that it meets the requirements to qualify for that status.

Although there is overlap between the registered and certified categories, in general the certified standards are more empirical and based on specific thresholds and fact patterns. FFIs seeking to meet the registered standards are subject to more procedural requirements, including due diligence reviews and oversight. It may be helpful to think of the category of registered deemed-compliant FFI as a somewhat simplified mechanism for complying with FATCA rather than as an exception to FATCA compliance.

There is a pattern of common characteristics among US Treasury’s selection of deemed-compliant FFIs. Barriers to entry by US persons, existing transparency and accountability to the home country, low-value accounts, minimal opportunities for personal inurement, and assurance of internal controls by doing business only with participating FFIs or deemed-compliant FFIs are prevalent standards. Even within the deemed-compliant regime there are gradations of risk; only those FFIs able to meet

the certified standards are able to escape direct interaction with the IRS completely, although they still must satisfy their withholding agents that they merit the status.

US Treasury revealed its ongoing struggle to find the right balance by indicating that requirements and procedures for deemed-compliant status may be modified in final regulations to prevent specific organizations or classes of organizations from circumventing the purposes of FATCA. US Treasury further signaled that this area of deemed-compliance is not settled and may continue to evolve even after final regulations are issued by stating that additional categories of deemed-compliant FFIs may be identified in any future guidance published in the Federal Register.

FFIs should carefully consider the benefits and burdens of deemed-compliant status before making decisions on how to proceed. Being categorized as deemed-compliant still may leave an FFI facing significant administrative burdens, and it may involve unwanted operational consequences, as well. For example, to qualify as a restricted fund an FFI may be required to terminate agreements with non-qualifying distributors. For some, however, the limited interface with the IRS to recertify once every three years may be preferable to annual information reporting.

A. Registered Deemed-Compliant FFIs

To obtain registered deemed-compliant status, an FFI must (a) have its chief compliance officer or an individual of equivalent standing with the FFI certify to the IRS that all requirements to qualify for deemed-compliant status have been met, (b) obtain from the IRS confirmation of its registration and an FFI-EIN, (c) agree that it will comply with procedures to publish a passthru payment percentage, as applicable, (d) renew its certification every 3 years, and (e) agree to notify the IRS of changes in circumstances that would make the FFI ineligible for deemed-compliant status.

A registered deemed-compliant FFI may use one or more agents to perform necessary due diligence and to obtain and maintain deemed-compliant status. However, the FFI remains ultimately responsible for ensuring the requirements have been met.

The regulations identify five categories of FFIs that may qualify for registered deemed-compliant status:

1. Local FFIs. An FFI with operations and account holders limited to its home country may qualify for deemed-compliant status. A local FFI must be licensed and regulated under the laws of its country of organization (which must be Financial Action Task Force (“FATF”)-compliant) as a bank or similar organization authorized to accept deposits, a securities broker or dealer, or a financial planner or investment adviser. It must have no fixed place of business outside its country of incorporation or organization and must not solicit account holders from outside the country. At least 98% of the FFI’s accounts must be held by residents (including entities) in the country of organization, and the FFI must be required under the laws of that country to provide information reporting or withholding on those accounts. An FFI organized in an EU member state may treat account holders that are residents of other EU member states as residents of the FFI’s country of organization or incorporation. On or before the date of registration as a deemed-compliant FFI, the local FFI must implement policies and procedures ensuring it does not open or maintain accounts of US specified persons, nonparticipating FFIs or entities controlled by specified US persons. The local FFI must review non-local accounts opened after December 31, 2011 and certify to the IRS that there are none, that they were closed, or that the FFI will withhold and report on the accounts as if it were a participating FFI. Each member of an expanded affiliated group must meet these requirements to qualify for deemed-compliant status.

2. Nonreporting members of participating FFI groups. An FFI that is a member of a participating FFI group may be excepted from FATCA reporting requirements if it meets the

following conditions. Existing accounts must be reviewed to identify any US accounts or accounts held by nonparticipating FFIs. If such accounts are identified, the FFI has 90 days to enter into an FFI agreement, transfer the account to an affiliate that is a participating FFI or US financial institution, or close the account; the FFI also must agree to comply with these same procedures for any new accounts opened after it registers with the IRS. The FFI also must put procedures in place to identify disqualifying accounts resulting from a change in circumstances, and agree to transfer those accounts to an affiliate or become a participating FFI within 90 days of discovery. This category follows Notice 2011-34 but (in response to comments) without the requirement that the deemed-compliant FFI operate in a single country and only solicit account holders in that country.

3. Qualified collective investment vehicles. Qualified collective investment vehicles (“QIVs”) may qualify as deemed-compliant FFIs if they are FFIs solely because they are investment vehicles. The QIV must be regulated in its country of incorporation or organization as an investment fund.¹⁰ Each holder of record of direct debt interests in excess of \$50,000 or equity interests in the FFI (*e.g.*, the holders of its units or global certificates) or any other account holder of a financial account with the FFI must be a participating FFI, a registered deemed-compliant FFI, an exempt beneficial owner, or a US person that is not a specified US person (*i.e.*, a publicly traded company, a regulated investment company, a real estate investment trust and other persons excepted from the definition of a specified United States person). All FFIs in the expanded affiliated group must be participating FFIs or registered deemed-compliant FFIs.

4. Restricted Funds. This category appears to be designed for Undertakings for Collective Investment in Transferable Securities (“UCITS”) funds and builds on a category described in Notice 2011-34. Like QIVs, restricted funds meet the requirements for deemed-compliant status if they are FFIs solely because they are investment vehicles. The FFI must be regulated in its country of incorporation or organization as an investment fund, and the country must be FATF-compliant.¹¹ An interest in the FFI may only be sold through a distributor (defined as an underwriter, broker, dealer, or other person who participates, pursuant to a contractual arrangement, in the distribution of securities) or redeemed directly by the restricted fund. Each distributor must be a participating FFI, a registered deemed-compliant FFI, a nonregistering local bank, or a restricted distributor.

The requirements for a restricted distributor may require changes to the way that shares in these funds are distributed. A distributor is a restricted distributor when (a) it provides investment services to at least 30 unrelated customers, (b) no more than half the distributor’s customers may be related persons, (c) the distributor performs AML due diligence procedures under the laws of its country of organization (which must be FATF-compliant), (d) the distributor operates solely in its country of incorporation or organization (which must be the same as other members of the affiliated group) and (e) it does not have a fixed place of business outside the country. The restricted distributor may (a) not solicit customers outside its home country, and (b) have no more than \$175 million in total assets under management and no more than \$7 million in gross revenues; if part of an affiliated group, the entire group must have no more than \$500 million in total assets under management and no more than \$20 million in consolidated gross revenues. The distributor must provide the FFI with a Form W-8 establishing that it meets the requirements to be a restricted distributor. The distribution agreement must prohibit securities from being distributed to any specified US persons, passive NFFEs with one

¹⁰ The proposed regulation do not indicate the level of regulation that is necessary. Thus, for example, it is not clear whether US Treasury would regard a Cayman Islands entity registered with the Cayman Islands Monetary Authority (“CIMA”) as meeting this requirement.

¹¹ FATF includes Ireland, Luxembourg and the United Kingdom, the three main jurisdictions in which UCITS funds are formed.

or more substantial US owners, and nonparticipating FFIs – any such distributions must be redeemed or canceled within 6 months and commissions foregone. Any sales after December 30, 2011 must be reviewed and accounts with US indicia redeemed.

The FFI is responsible for ensuring that each distribution agreement prohibits sales of debt or equity interests in the FFI to US persons, nonparticipating FFIs and passive NFFEs with one or more substantial US owners (other than interests both distributed by and held through a participating FFI), and all marketing materials must state that sales of interests to such persons are prohibited. A distributor must notify the FFI within 90 days of a change in status, the FFI must terminate its distribution agreement with the distributor within 90 days of notification, and the FFI must acquire or redeem all debt and equity interests issued through that distributor within 6 months of the change in status.

Preexisting accounts held directly by the ultimate investors must be reviewed by the FFI to identify US accounts or accounts held by a nonparticipating FFI unless the FFI's distribution agreements and its prospectus contained an explicit prohibition on issuance of shares to US entities and US resident individuals at the time the interests were acquired. Upon review, the FFI must certify to the IRS either that it did not have those types of accounts, that the accounts will be redeemed, or that the FFI will withhold and report on the accounts as though it were a participating FFI.

Before registering with the IRS, the FFI must implement policies and procedures to (a) identify direct account holders to ensure it does not open or maintain an account for any specified US person, nonparticipating FFI or passive NFFE with one or more substantive US owners, or (b) close any new account of such persons within 90 days of opening or the date that the FFI knew such persons held the account; alternatively, the FFI could agree to withhold and report on the account as though it were a participating FFI. All FFIs in the expanded affiliated group must be participating FFIs or registered deemed-compliant FFIs.

5. FFIs subject to intergovernmental agreement. FFIs that comply with FATCA according to the terms of an intergovernmental agreement between the US and a foreign FATCA partner will qualify for deemed-compliant status. To date, the US, France, Germany, Italy, Spain and the United Kingdom have agreed to pursue intergovernmental arrangements for information reporting and information sharing.

B. Certified Deemed-Compliant FFIs

The regulations identify five categories of FFIs that may qualify for certified deemed-compliant status:

1. Nonregistering local banks. To qualify as certified deemed-compliant, a local bank must operate and be licensed solely as a bank in its country of incorporation or organization and engage primarily in the business of making loans and taking deposits from unrelated retail customers. It must have no fixed place of business, nor solicit account holders, outside its home country. The FFI must have no more than \$175 million in assets on its balance sheet, and if it is part of an expanded affiliated group, the group must have no more than \$500 million in total assets on the consolidated balance sheet. The FFI must be required by its home country to perform information reporting or withholding on resident accounts. If all the accounts maintained by the FFI have a value or account balance of \$50,000 or less, the information reporting and withholding requirements are waived. Each FFI in the expanded affiliated group must be incorporated or organized within the same country and meet all deemed-compliant requirements.

2. Retirement plans. An FFI organized for the provision of retirement or pension benefits may be certified deemed-compliant if it meets one of the following groups of requirements.

- Group A. In general, all contributions to the FFI must be employer, government, or employee contributions limited by reference to earned income. No single beneficiary may have a right to more than five percent of the FFI's assets. Contributions that otherwise would be subject to tax must be deductible or excludible from the gross income of the beneficiary, taxation of the investment income is deferred, or 50% or more of the total contributions to the FFI are from the government and the employer.
- Group B. The FFI has fewer than 20 participants. The FFI is sponsored by an employer that is not an FFI or a passive NFFE. Contributions to the FFI are limited by earned income. Non-resident participants are limited to 20% of the FFI's assets and may not be entitled to more than \$250,000 of the FFI's assets.

3. Non-profit organizations. Non-profits must be established and maintained exclusively for religious, charitable, artistic, cultural or educational purposes and be exempt from tax in the home country. There must be no shareholders or members with a proprietary or beneficial interest in income or assets. No income or assets of the FFI may be distributed to, or used for the benefit of, a private person or noncharitable FFI except in connection with the non-profit FFI's activities, or as reasonable compensation for services rendered, or as fair market value for property purchased by the FFI. Upon liquidation or dissolution, all of the FFI's assets must be distributed to a foreign government or another non-profit meeting the certified deemed-compliant requirements.

4. FFIs with only low-value accounts. To qualify in this category, FFIs must be depository or custodial institutions. No account held by the FFI, or other FFIs in the expanded affiliated group, may have a balance greater than \$50,000; neither the FFI nor its entire expanded affiliated group may have more than \$50 million in assets on the balance sheet as of the end of the most recent accounting year.¹²

5. Owner-documented FFIs. Only FFIs that are investment vehicle FFIs, and not depository, custodial or insurance FFIs (or affiliated with such entities), may qualify for owner-documented certified deemed-compliant status. This status does not apply to payments or accounts for which the FFI acts as an intermediary. The FFI may not maintain a financial account for any nonparticipating FFI, nor may the FFI issue debt constituting a financial account to any person in excess of \$50,000. For owner-documented FFIs, certified deemed-compliant status applies only to payments received by, and accounts held with, a designated withholding agent, *i.e.*, a US financial institution or a participating FFI. A designated withholding agent is a withholding agent that agrees to conduct the due diligence and reporting required in order to treat the FFI as an owner-documented FFI. The FFI must supply the designated withholding agent with all documentation required of an owner-documented FFI, including any necessary waivers, associated with each individual, specified US person, owner-documented FFI, exempt beneficial owner, or NFFE that holds, directly or indirectly, an interest in the payee. The withholding agent will report to the IRS regarding the owner-documented FFI's direct or indirect owners that are specified US persons.

V. Passthru Payments

An FFI agreement will require an FFI to withhold on "passthru payments" made to recalcitrant account holders or other FFIs that have not entered into information-sharing agreements ("non-

¹² See *supra* note 8

participating FFIs”). A “passthru payment” is (1) any withholdable payment or (2) any other payment to the extent attributable to a withholdable payment. This second category of passthru payment is referred to, but not yet defined, in the proposed regulations as a “foreign passthru payment.” Alternatively, a participating FFI may elect to provide information so that a withholding agent (including another FFI) can determine, and withhold tax from, the portion of any passthru payment allocable to recalcitrant account holders and non-participating FFIs. Without these mechanisms for withholding on passthru payments, an FFI might face withholding on all withholdable payments it receives, even if the information-sharing problems resulted from the actions of only a small number of account holders.

Notice 2011-34 set forth US Treasury’s first attempt at establishing rules for determining when payments made by an FFI are “attributable” to withholdable payments received by the FFI. That approach was based on the ratio of the FFI’s US assets to total assets (the “passthru payment percentage”), rather than direct tracing to withholdable payments.

The approach of Notice 2011-34 was widely criticized for its cost, complexity and breadth. The proposal would have made it difficult for an FFI to “elect out” of FATCA by avoiding US investments, because indirect investments in US assets could so easily be captured as passthru payments. In response to these comments, the proposed regulations provide that no withholding will be required with respect to foreign passthru payments before January 1, 2017. However, FFIs will be required to report annually on the aggregate amounts of certain payments to each nonparticipating FFI for the 2015 and 2016 calendar years.

VI. Grandfathered Obligations

The FATCA legislation provided an exception from withholding for payments on, and gross proceeds from the disposition of, certain “grandfathered obligations” so that financing by non-US issuers would not be disrupted while FATCA was being implemented. The proposed regulations extend the date by which obligations must be issued in order to be considered grandfathered obligations and provide further guidance on what constitutes an obligation for this purpose.

Under the proposed regulations, any obligation outstanding on January 1, 2013 will be considered a grandfathered obligation. In other words, payments on, and proceeds from the disposition of, any obligation issued before that date will not be subject to FATCA withholding. This extends the March 18, 2012, date set forth in the FATCA legislation, which was two years after enactment, in order to give withholding agents and FFIs more time to implement FATCA. The proposed regulations follow the FATCA Notices in providing that a grandfathered obligation will lose its status as such if it undergoes a material modification on or after January 1, 2013. A material modification is any “significant modification” as defined in the current regulations dealing with deemed exchanges of debt instruments or, in the case of other obligations, any modification that is material based on all the facts and circumstances.

The proposed regulations generally adopt the definition of the term “obligation” set forth in Notice 2011-53 – any legal agreement that produces or could produce a withholdable payment or passthru payment, other than an instrument that is treated as equity for US tax purposes or that lacks a stated expiration or term. The proposed regulations also provide the following specific examples:

- any debt instrument as defined in the Code provisions for original issued discount obligations (section 1275(a)(1));

- a binding agreement to extend credit for a fixed term, such as a line of credit or revolving credit facility, provided that on the agreement’s issue date the agreement fixed the material terms including a stated maturity date;
- a life insurance contract payable upon the earlier of attaining a stated age or death and a term certain annuity contract; and
- a derivatives transaction entered into between counterparties under an ISDA Master Agreement and evidenced by a confirmation (but the master agreement itself is not an obligation if it merely sets forth general and standard terms).

The proposed regulations also make clear that payments with respect to a grandfathered obligation include income allocated to a partner or trust beneficiary with respect to payments received by the partnership or trust.

VII. There’s More Than One Way to Skin a Cat: An Intergovernmental Approach to Implementing FATCA

A. *The Joint Statement*

Largely lost in the shuffle of the 400 pages of FATCA regulations was a three-page document released on the same day describing an intergovernmental approach to implementing FATCA. The United States, together with France, Germany, Italy, Spain and the United Kingdom, issued a “Joint Statement regarding an Intergovernmental Approach to Improving International Tax Compliance and Implementing FATCA” (“Joint Statement”) that announced their agreement to “explore a common approach to FATCA implementation through domestic reporting and reciprocal automatic exchange and based on existing bilateral tax treaties.” This framework represents an imaginative use by US Treasury of the extensive regulatory authority granted in the underlying FATCA legislation.

The Joint Statement envisions an agreement between the US and any of these “FATCA partner” countries that would provide an alternative mechanism for FFIs to comply with FATCA. Instead of the FFI entering into an agreement with, and providing information directly to, the IRS, an FFI in a partner country would report FATCA-type information to its home country, which in turn would provide the information to the IRS on an automatic basis. Presumably the customer due diligence procedures and account information would be consistent with FATCA principles. FFIs in the country would be treated as participating FFIs or deemed-compliant FFIs. The agreement between the US and the partner country would identify categories of FFIs that would be considered deemed-compliant or presenting a low risk of tax evasion. The partner country would enact enabling legislation as necessary to authorize FFIs to collect and report the data.

In turn, the FFI’s obligations to the US would be significantly curtailed and limited to registering with the IRS as a registered deemed-compliant FFI (if not excepted from registration requirements consistent with IRS guidance or the terms of the partner agreement). FFIs in partner countries would not be required to enter into an agreement with the IRS or report account information directly to the IRS. Because the FFIs would be considered participating or deemed-compliant, there would be no withholding on US-source payments to FFIs in the partner country. The advantages to the FFIs in a partner country would be considerable. They would not be required to terminate the account of a recalcitrant account holder. Neither would they be required to withhold on payments to recalcitrant account holders, nor would they have to withhold on payments to other FFIs in their home partner country or in any other partner countries that have an agreement with the United States. It is unclear whether account holders in those countries would be similarly advantaged; concerns have been raised

as to whether the government of the partner country would use the information intended for the IRS for its own tax enforcement purposes.

The intergovernmental framework substantially mitigates some of the burden, privacy and legal concerns of FFIs that have proven to be primary obstacles as US Treasury works to implement the FATCA legislation. However, arguably the most significant aspect of the intergovernmental framework has nothing to do with ameliorating the challenges that the foreign financial institutions are facing.

B. The “Sleeper” Issue

Instead, there is a much larger “sleeper” issue embedded within the intergovernmental FATCA framework that will impose significant new data collection and reporting requirements on United States financial institutions and withholding agents. In exchange for allowing FFIs to report directly to their home country, the United States would agree to collect account information on residents of the FATCA partner and automatically report such information to the authorities in the partner country. This reciprocal, automatic exchange of information would be a sea change from existing US information reporting practices, and it is sure to be controversial.

To demonstrate, in January 2011, US Treasury issued proposed regulations that require information reporting to the IRS on bank deposit interest paid to nonresident alien individuals who are residents of any foreign country (“the NRA rules”). Although the proposed regulations do not require the IRS to share this information with the nonresident alien’s home country, US Treasury’s explanation of the rules states that routine reporting of bank deposit interest paid to non-US persons will “further strengthen the US exchange of information program,” and it is generally anticipated that the data collected will eventually be shared with other countries. The NRA rules have been vehemently opposed by many, including those who say individuals and their families will be put at risk if the home country learns they have assets in the United States.

Although controversial, the intergovernmental framework would be consistent with the overall strategy of US Treasury. On February 28, 2012, the Financial Crimes Enforcement Network (“FinCEN”) issued an Advanced Notice of Proposed Rulemaking that would strengthen and clarify customer due diligence (“CDD”) requirements. In its announcement, FinCEN stated that “an express CDD program rule is one key element of a broader US Treasury strategy to enhance financial transparency in order to strengthen efforts to combat financial crime.”

US Treasury is not alone in its commitment to increased transparency and information sharing. Since their first Summit in Washington in November 2008, the G20 leaders have consistently called for improvements to tax transparency and exchange of information so that jurisdictions can fully enforce their tax laws to protect their tax bases. The OECD Global Forum on Transparency and Exchange of Information for Tax Purposes members (over 100 jurisdictions plus the European Union) have committed to implementing the internationally agreed standard on transparency and exchange of information, and the Forum has established an in-depth peer review mechanism to monitor the implementation of the globally endorsed tax transparency standard.

On February 20, 2012, the Director of Mexico’s Tax Administration Service, Alfredo Gutierrez Ortiz Mena, announced that “[S]oon, very soon, the Mexican Treasury may automatically request information of Mexicans with bank accounts in United States that may be useful to combat tax evasion,” suggesting that behind-the-scenes discussions between Mexico and the United States have already taken place.

And the Joint Statement itself suggests the intergovernmental framework is just the beginning of a worldwide surge toward increased transparency and accountability. The final section in the statement captures a commitment among the United States, France, Germany, Italy, Spain and the United Kingdom to work with other FATCA partners, the OECD, and the EU to adapt FATCA in the medium term to a common model for automatic exchange of information.

C. Intergovernmental Framework Not a Done Deal

Contrary to the way the Joint Statement has been portrayed in the press, the intergovernmental framework is not a done deal. Discussions among the countries are ongoing and confidential. US Treasury officials hope to finalize the FATCA regulations by the end of this summer, and have a similarly ambitious (and perhaps unrealistic) schedule for instituting the intergovernmental framework with FATCA partners. In the meantime, the announcement of the framework has created more confusion and questions than answers.

FFIs in France, Germany, Italy, Spain and the United Kingdom are wondering what they should be doing to prepare for FATCA. Should they ignore FATCA and wait for the intergovernmental agreement with their home country? Or should they be ready to comply with FATCA in case the framework falls apart? If final FATCA regulations are promulgated before consensus is reached on an intergovernmental approach, or before enabling legislation can be enacted in the partner country, will FFIs in tentative FATCA partner jurisdictions be granted an extension of time to get ready? Because the requirements of the framework are envisioned to be similar to FATCA itself, some US Treasury officials recommend against holding off. Yet, until the details of the framework are finalized, much like the FATCA regulations themselves, premature implementation could prove costly and unnecessary.

As with the FATCA regulations themselves, the announcement of the intergovernmental framework offers opportunities for foreign and domestic stakeholders to weigh in with US Treasury and potential FATCA partners to help shape legislation, agreements and procedures.

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