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Summer Brings FATCA Relief After an April Shower of FATCA Guidance: Notices 2011-34 and 2011-53

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Prior to the release of Notice 2011-53 [1] on July 14, 2011, Treasury officials had acknowledged in public remarks[2] the need for transition rules and pointed to the broad regulatory authority given to Treasury relating to implementation of the Foreign Account Tax Compliance Act (FATCA). With 18 months remaining until the January 1, 2013, effective date and only two notices addressing limited, albeit important, issues, it had become increasingly clear that transition rules would be needed to phase in the FATCA provisions. Concern was rising among foreign financial institutions (FFIs) about their ability to be ready for compliance without the benefit of even proposed regulations.

As computer systems and new account opening procedures need to be developed, local country regulators may need to approve new contractual arrangements, and personnel need to be trained, Notice 2011-53 provides a phased-in FATCA implementation schedule that should permit FFIs to become prepared for FATCA compliance, the first stage of which will begin as of January 1, 2014. FFIs will need to enter into an FFI Agreement (FFIA) with the Internal Revenue Service (IRS) before June 30, 2013, in order to ensure not being subject to withholding as a non-participating FFI (Non-PFFI). In public remarks, IRS Commissioner Douglas Shulman noted that the phase-in schedule provided by Notice 2011-53 "recognizes the operational realities faced by financial institutions." [3] If anyone had any doubts about whether the FATCA provisions would be implemented, it is clear from Notice 2011-53 and the accompanying IRS news release [4] that implementation will occur.

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[1] 2011-32 I.R.B. 124.

[2] For example, see the remarks of Jesse Eggert, Associate International Tax Counsel, Office of Tax Policy, on June 10, 2011, before the International Tax Institute, Inc., T.A. Doc. 2011-12628. Section 1474(f) provides regulatory authority to prescribe regulations or other guidance as may be necessary or appropriate to carry out the purposes of, and prevent the avoidance of, chapter 4. Unless otherwise specified, all section ("§") references are to the Internal Revenue Code of 1986, as amended, or the regulations thereunder.

[3] Reuters Online, UPDATE 2 — IRS Allows More Time on New U.S. Anti-Tax Evasion Law (7/14/11).

[4] IR-2011-76. In that news release, Commissioner Shulman stated: "Today's notice is a reflection of our serious commitment to implementation of the statute, but also a serious commitment to

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Notice 2011-34,[5] issued on April 8, 2011, provides new account procedures for pre-existing individual accounts, significantly streamlining the prior procedures (which were replaced in their entirety). In addition, the notice provides first-time guidance on the definition of a ''passthru payment'' and additional new categories of deemed-compliant FFIs (DCFFIs). Other guidance relates to revised reporting requirements, treatment of Qualified Intermediaries, and expanded affiliated groups. Guidance concerning the effective date of an FFIA was superseded by Notice 2011-34.

CONFLICT OF LAWS

The major threshold issue continues to be the conflict of FATCA with local country laws such as data protection or privacy laws. Until the Treasury Department reaches an accommodation with other governments, FFIs may be subject to various local law sanctions (e.g., loss of business license, fines, or even criminal sanctions) if they comply with the FATCA reporting requirements. Government-to-government discussions apparently are taking place, but there has been no publicly announced resolution yet.[6] Notice 2010-60[7] does note, however, that the information could be aggregated and provided to the IRS without identifying personal information. Furthermore, Notice 2010-60 [8] suggests that the treaty exchange of information process may provide an avenue for such aggregate information to be reported.

However, Treasury officials have noted that the existence of an Exchange of Information Agreement, whether free-standing or embedded in an income tax treaty, is not sufficient because currently treaty partners do not provide the United States with FATCA-required information.[9] These comments suggest that the Competent Authorities may need to enter into specific agreements concerning FATCA reporting.

listen to the implementation challenges of affected financial institutions and make appropriate adjustments to ensure a smooth and timely roll-out.''

[5] 2011-19 I.R.B. 765. As was Notice 2010-60, Notice 2011-34 was issued on a Friday afternoon. Midnight of April 8, 2011, was the deadline for further funding of the U.S. government and by the afternoon of April 8 there was great uncertainty on whether the U.S. government would be shut down.

[6] Reported remarks of Manal Corwin, Deputy Assistant Secretary (International Tax Affairs), *Wall Street Journal* (6/23/11): ''We're talking with foreign governments to figure out how we can implement FATCA in a cooperative way.''

[7] 2010-37 I.R.B. 329.

[8] §V(H) of the Notice.

[9] *See* remarks of Michael Plowgian, Attorney-Advisor, Office of Tax Policy, on June 29, 2011, during the BNA FATCA Webinar ''Update on FATCA Guidance — How It Will Affect You'' (''Plowgian BNA Remarks'').

NOTICE 2011-53: PHASED-IN IMPLEMENTATION SCHEDULE

Notice 2011-53 delays both the FATCA §1471 withholding and reporting requirements one year to January 1, 2014, and phases in those requirements over two years starting in 2014. The revised version of Notice 2011-53 extends the application of the phase-in to §1472 as well.[10] See Appendix A for a detailed presentation of the time schedule. This delay in the withholding and reporting procedures should allow enough time to permit FFIs to build their computer systems, request and receive any required regulatory approvals, and train appropriate personnel to comply with the rules. Of course, whether enough time has been provided depends on the resolution of the conflict-of-law issues and the promulgation of proposed regulations by December 31, 2011, and final regulations by the summer of 2012.

Registration of FFIs as Participating FFIs

The opening of registration of FFIs as participating FFIs (PFFIs) will begin no later than January 1, 2013. An FFI that does not register as a PFFI prior to June 30, 2013, may be subject to withholding beginning on January 1, 2014.[11] Presumably, a PFFI that registers after June 30, 2013, and is withheld on because its status as such was not obtained by the June 30, 2011 deadline, will be able to obtain a refund of tax for itself and any non-recalcitrant account holders. The fact that a late-acquired PFFI status could subject an FFI to withholding may be a competitive advantage for those FFIs that obtain their PFFI status prior to June 30, 2013.

The June 30, 2013, deadline also has another effect because the implementation of the due diligence requirements, discussed below, is keyed to the effective date of an FFIA. Thus, the sooner the FFIA is executed, the sooner the due diligence requirements must be completed by a PFFI.

The threat of withholding may also cause a large number of FFIs to apply within a short time period. If the registration is not opened until January 1, 2013, it could be difficult for the IRS to process the number of applications within a six-month period. The potential applicant pool is certainly very large and includes every FFI in the world (estimated by some at more than 750,000). FFIs that timely apply for PFFI status should not be penalized. Hopefully, the IRS will implement internal procedures that will permit it to process PFFI applications in a timely manner even if

[10] See corrected Notice 2011-53, released July 25, 2011.

[11] Notice 2011-53, §II.A.

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the registration process is conducted in a compressed time period.

Withholding Implementation

The first tranche of withholding that begins on January 1, 2014, applies only to U.S.-source fixed or determinable annual or periodical (FDAP) income. Withholding on gross proceeds from the sale of an asset that produces FDAP and on passthru payments will not begin until January 1, 2015 (unless a passthru payment includes U.S.-source FDAP, in which case the U.S.-source FDAP portion of the passthru payment will be subject to withholding on January 1, 2014).

Reporting Implementation

For the first year in which reporting will be required, only a limited amount of data about U.S. accounts needs to be reported to the IRS; however, an FFI may elect to report all of the information required under Notice 2011-34.[12] Although the limited reporting would appear to be helpful, likely it is easier to build only one reporting module for a computer program rather than have a separate one-year program.

Reporting for post-2013 and subsequent years will be governed by the procedures in Notices 2010-60 and 2011-34 and as implemented in future regulations.[13]

Due Diligence

The due diligence procedures for new accounts will be applicable to accounts opened on or after the effective date of an FFI's FFIA.[14] For pre-existing accounts, the due diligence procedures must be implemented within either one or two years of the effective date of an FFI's FFIA.[15] For private banking accounts equal to $500,000 or more, the due diligence on those accounts must have been completed within one year of the effective date of an FFI's FFIA.[16] These larger accounts are the accounts with the highest risk of tax avoidance, so it is not surprising that the due diligence requirements are not only more stringent but also must be completed at a faster pace. As noted above, the June 30, 2013, PFFI registration deadline for ensuring no withholding will accelerate the completion of the due diligence requirements.

[12] *Id.* §II.B.1.

[13] *Id.* §II.B.2.

[14] *Id.* §II.A.2.a.

[15] *Id.* §II.A.2.b.

[16] *Id.* §II.A.2.b.i.

Substantive Guidance Provided by Notice 2011-53

Application of the Grandfather Provision to Passthru Payments

Notice 2011-34 provided the first guidance as to how the passthru payment provision will work, which is discussed below. Helpfully, Notice 2011-53 provides that legal agreements that produce passthru payments are covered by the grandfather provision.[17] Notice 2010-60 provides guidance on the scope of the term ''obligation,'' which includes any legal agreement that (i) produces or could produce certain types of U.S.-source FDAP income and (ii) has a definitive expiration or term. Excluded from this definition of ''obligation'' are savings deposits, demand deposits, and other similar accounts because they do not have a definitive expiration or term.[18]

Even though the definition of the term ''obligation'' is very broad, questions remained as to whether its scope would include passthru payments. Notice 2010-60 did not address whether passthru payments could be eligible for the grandfather exception because it did not address passthru payments at all. Whether the grandfather exception may apply to passthru payments is of great importance to the insurance industry because pre-existing life insurance contracts would prevent any withholding on any payments made under those contracts. Consequently, a life insurance company would be forced to pay the 30% withholding as an additional cost to it while the ''recalcitrant contract owner'' would not incur any cost even though the withholding is designed to encourage compliance on the part of account holders. The application of the grandfather exception to insurance contracts issued by foreign insurance companies will ameliorate that situation. The extension of the grandfather provisions to passthru payments should be helpful for other FFIs as well.

Certainly, the fact that the grandfather provision will apply to passthru payments signals that a liberal application will prevail. Most practitioners now expect that most revolver provisions, which follow the LSTA Model Lending Agreement, also will be covered by the grandfather provision, which had been of concern until recently.[19] The purpose of the grandfather provision is to avoid disruption of existing com-

[17] *Id.* §IV.B. Section 501(d) of the HIRE Act provides for grandfathered treatment of obligations outstanding on Mar. 18, 2012, under which payments and gross proceeds from a disposition of an obligation in existence on Mar. 18, 2012, will not be subject to withholding under FATCA. Reporting, however, will be required on such grandfathered obligations.

[18] Notice 2010-60, §I.

[19] In public remarks, Michael Plowgian explained that the ques-

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mercial contracts, so the treatment of most contracts as being within the scope of the grandfather provision is consistent with the underlying policy goals of the grandfather provision.[20]

Proposed Regulations To Incorporate Guidance in Notices 2010-60 and 2011-34

Part III of Notice 2011-53 announces that proposed regulations will incorporate the guidance provided in Notice 2010-60, as amended and supplemented by Notice 2011-34. The implication is that the procedures provided in that guidance may not be substantially changed in the proposed regulations; consequently, the regulations may not offer a more limited review of account files, as some FFIs had requested. Additionally, the decrease in the threshold for high-value accounts, from $1 million to $500,000, would appear to be incorporated in the proposed regulations at least for bank FFIs.

Private Banking Procedures

Further guidance on the scope of the private banking procedures and the associated required searches of account holder files is to be provided in the regulations.[21] The scope of the current definition of ''private banking account'' in Notice 2011-34 has been criticized as too broad, and government officials have publicly stated that the definition will be revised to narrow its scope so that only high-risk accounts will be covered.[22]

NOTICE 2011-34 GUIDANCE

Revised Pre-Existing Individual Account Procedures

One of the most difficult issues in the implementation of FATCA is the need to identify U.S. accounts out of the millions of pre-existing accounts that were opened prior to the enactment of the FATCA legislation. Although in many countries know-your-customer and anti-money laundering requirements applied at the time of the establishment of the account, the data required by FATCA was not necessarily collected — with the result that most FFIs do not have the required information. Moreover, as such pre-existing account holders likely will not provide FATCA information after-the-fact or a waiver for local law data protection purposes (assuming that the conflict of law is resolved), they likely will become ''recalcitrant account holders'' subject to withholding. However, because many FFIs are unable to withhold from such ''recalcitrant account holders'' because of either contractual obligations or local laws, the treatment of pre-existing accounts is one of the most crucial issues. FFIs that are unable to withhold on payments to ''recalcitrant account holders'' will be forced to pay the 30% withholding as an additional cost of their business. Thus, the ''stick'' provision of FATCA designed to force account holders to comply with documentation requirements will not achieve its goal with respect to pre-existing accounts where the FFI (and not the account holder) bears the economic cost of the 30% withholding.

For these reasons, Treasury has revised the pre-existing account holder procedures in order to increase the number of accounts that will *not* be treated as U.S. accounts. An important element is the regulatory elective extension of the $50,000 depository account exception to *any* account of $50,000 or less.[23] Neither of these categories of accounts will be treated as U.S. accounts subject to FATCA reporting and withholding requirements. By extending the statutory deposit exception to all accounts, Treasury has eliminated the bulk of all accounts from FATCA requirements. Moreover, under the new procedures, once an FFI has determined that an account is subject to one of the $50,000 exceptions, the FFI does not need to test those accounts again.

This additional extension also reflects a strategy of identifying those accounts for which the potential for substantial tax evasion is highest. Such a high-risk identification strategy has a two-fold benefit. First, it reduces the administrative burden on FFIs because it reduces the number of accounts for which the FFI must apply the account identification procedures and second, for the IRS, it identifies only those accounts that would have substantial tax evasion potential. It remains to be seen whether the new elective nondepository $50,000 exception will be expanded to new accounts, although public remarks by government of-

tion is, ''Does that agreement give rise to the withholdable payments?'' If it does, ''it falls within the definition of 'obligation' under Notice 2010-60.'' Plowgian BNA Remarks.

[20] As articulated by Plowgian, the reason for the grandfather provision was the recognition that ''it was going to take Treasury and the IRS a significant period of time to provide guidance under chapter 4. Congress recognized that they didn't want that uncertainty to disrupt the market.'' Consequently, Notice 2010-60 interprets ''obligation'' in a ''very broad manner.'' The interpretation includes any legal agreement that gives rise or could give rise to withholdable payments. *Id.*

[21] Notice 2011-53, §II.A.2.b.iv.

[22] Remarks by Michael Plowgian (Treasury Attorney-Advisor) and Danielle Nishida (IRS ACCI Attorney-Advisor) during the June 30, 2011 video conference sponsored by the Canadian Bankers Association, the Canadian Life and Health Insurers Association, and the Investment Industry of Canada (''Plowgian and Nishida Remarks'').

[23] Notice 2011-34, §I.A.2, Step 2.

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ficials would make such an expansion seem unlikely.[24]

Comparison with Notice 2010-60 Procedures

One of the most burdensome aspects of the pre-existing individual account procedures was the requirement to apply the new account procedures within either one year (for accounts over $1 million) or five years (for accounts less than $1 million), which would require more than electronic searches. Notice 2011-34 eliminates those requirements and replaces them with a more streamlined set of procedures that do not require pre-existing accounts to meet the new account standards and limits account identification procedures to electronic searches, except for private banking accounts and accounts of $500,000 or more.

As an additional effort to limit the burden for FFIs, Notice 2011-34 requires the aggregation of accounts for purposes of applying the $50,000 exception only where an FFI is already aggregating the accounts such as in a computerized system. The plain import of the aggregation rule is that if an FFI does not aggregate accounts for its own purposes, the $50,000 exception is applied separately to each separate account.

Pre-existing accounts of less than $500,000 (except private banking accounts) are subject only to electronic file searches for indicia of U.S. status, which are the same indicia as under Notice 2010-60, except that foreign post office box numbers are no longer treated as an indicia of U.S. status. This change was made in response to commentators who noted that many countries do not have postal street addresses.[25] Private banking accounts and other accounts of $500,000 or more are subject to ''diligent'' review.

Finally, it should be noted that the Notice 2011-34 account identification procedures lower the threshold for large accounts from $1 million to $500,000.

New Private Banking Accounts and Accounts of $500,000 or More

Notice 2011-34 also introduces two new categories of pre-existing accounts for which ''diligent review'' is required, which is presumably not limited to electronic searches, but requires examination of paper or other types of files as well. Those categories are ''private banking accounts'' and accounts equal to or greater than $500,000.[26] Again, the emerging rules focus the most stringent requirements on those accounts with the most significant tax evasion potential, i.e., the larger accounts. By reducing the number of accounts subject to more stringent review requirements, the administrative burden on FFIs should be correspondingly reduced.

The ''private banking account'' category is designed to identify for this heightened scrutiny high-risk accounts for which an FFI presumably already has obtained a significant amount of information about the private banking clients. In addition to searches of electronic files, review of other than electronically searchable data files is required. Presumably the bank managers who handle such accounts would know whether the holder is a U.S. citizen or resident, or whether there is U.S. indicia present.

The latter category of accounts, i.e., those of $500,000 or more, again identifies high-balance accounts that pose the most significant risk of U.S. tax evasion. Although a number of commentators have requested a threshold limitation of $1 million, Notice 2011-53 indicates that the $500,000 threshold will be adopted by the regulations.

Identification Procedures for Pre-Existing Individual Accounts

The revised pre-existing individual account procedures provide detailed steps or ''drills'' that an FFI must follow in identifying U.S. accounts among its pre-existing individual accounts. As noted above, these procedures replace in their entirety the procedures set out in Notice 2010-60. The following is a detailed description of each step of the applicable procedures.

Aggregation of Accounts

Significantly, as mentioned earlier, the aggregation rule has been relaxed to require aggregation only if the FFI itself currently links accounts through its internal computer systems. Notice 2011-34 explains that this change was in response to the concerns of commentators who said that many FFIs would be unable to aggregate accounts maintained by branches or affiliates across jurisdictions or because of technology system limitations.

Determination of Account Balance

To determine whether an account meets the $50,000 exception, the new procedures look to the account balance at the end of the calendar year preceding the effective date of an FFI's FFIA rather than

[24] Plowgian and Nishida Remarks.

[25] Note also that for §1441 purposes, P.O. box addresses are acceptable. *See* Pub. 515 (Rev. March 2011), p. 7.

[26] Notice 2011-34, §I.A.2, Steps 3 and 5, respectively.

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testing the average of the month-end balances as required by Notice 2010-60.[27]

Step 1: Documented U.S. Accounts

If an account holder is already documented as a U.S. person for other U.S. tax purposes, that account holder will be treated as a U.S. person, and the account holder's financial accounts will be treated as "U.S. accounts" under §1471(d)(1). However, unless the FFI elects otherwise, an account still will be considered a non-U.S. account if: (1) the account is a depository account; (2) each holder of such account is a natural person; and (3) the balance or value of such account as of the end of the calendar year preceding the effective date of the FFIA does not exceed $50,000 (or the equivalent in foreign currency). The significance of non-U.S. account status is that the withholding and reporting provisions are not applicable. Note that the $50,000 exception in Step 1 applies only to depository accounts owned by individuals and reflects the statutory exception provided by §1471(d)(1)(B).

Step 2: Nondepository Accounts of $50,000 or Less

Step 2 provides a new regulatory *de minimis* exception, which derives from data provided by various FFIs that a high percentage of their nondepository accounts are below $50,000.[28] From the accounts not identified as U.S. accounts in Step 1, the FFI may treat a nondepository account as a non-U.S. account if the balance or value of the account as of the end of the calendar year preceding the effective date of the FFIA does not exceed $50,000 (or the equivalent in foreign currency). The purpose of this new nondepository $50,000 exception is to reduce the number of *pre-existing* accounts subject to the FATCA provisions. Based upon public remarks by IRS and Treasury officials, it does not appear that this regulatory exception will be extended to new accounts.[29]

Thus, a nonbank FFI should receive a benefit from this new regulatory exception. It is not clear how an analogous exception will be provided for life insurance policies with cash value that may be measured by cash value on redemption, a single premium amount, or a face value amount.

Step 3: Private Banking Accounts

Notice 2011-34 requires FFIs to perform detailed steps with respect to private banking accounts, which are any accounts that are maintained by an FFI's private banking department or maintained as part of a private banking relationship and are not addressed by Steps 1 or 2.

The term "private banking department" is broadly defined as any department, unit, division, or similar part of an FFI that is referred to by the FFI as a private banking, wealth management, or similar department and focuses on service to individual clients with certain thresholds of income, earnings, or assets. Moreover, the definition includes any part of an FFI that is considered a private banking department under the anti-money-laundering or know-your-customer requirements or in which an FFI's employees provide personalized services to an account holder.[30]

Commentators have noted that the definition is too broad or is not reaching the types of high-risk accounts that the government needs to identify. In particular, the part of the definition that sweeps in any account managed by a department with the name "private banking" or "wealth management" has been criticized as too broad.[31] For insurance companies, their entire business is in some way designed to manage wealth, so if the concept is extended to certain types of insurance contracts, clearly the definition is too broad. Treasury officials have publicly stated that they are open to suggestions to improve the definition.[32]

A complete description of the steps for private banking accounts is contained in Appendix B.

Significantly, an electronic search is not sufficient for an account identified as a private banking account; rather a "diligent" review of existing information is required. Furthermore, the identification procedures required must be completed within one year of the effective date of the FFI's FFIA. Notice 2011-53 announced that regulations will provide further guidance on the scope of the private banking procedures and the associated search of account holder files.[33]

The private banking account records must be searched for U.S. indicia. Significantly, the reporting obligations are imposed on individual private banking relationship managers who presumably maintain or know personal information about their individual clients. Notice 2011-53, however, provides that regula-

[27] Notice 2010-60, §II.B.2.a.

[28] Plowgian BNA Remarks.

[29] Plowgian and Nishida Remarks.

[30] Notice 2011-34, §I.A.1.3.

[31] See the joint comment letter dated June 13, 2011, from the European Banking Federation and the Institute of International Bankers at 17. "For example, for marketing reasons, many banks use terminology similar to that contained in the Notice's description of private banking account to describe accounts that are held by retail local-market customers, with modest account balances."

[32] Plowgian BNA Remarks.

[33] Notice 2011-53, §II.A.2.b.iv.

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tions will permit a PFFI to designate any person to review the account files.[34]

If, following the initial search of the account files, a private banking account manager becomes aware of the presence of one or more of the U.S. indicia, discussed below, the private banking account manager must obtain the appropriate documentation to classify the account.[35] Furthermore, if an account holder is identified as having a U.S. birthplace, the FFI is required to obtain a written explanation of either renunciation of the account holder's U.S. citizenship or an explanation of nonacquisition of U.S. citizenship at birth.[36]

Step 4: Accounts with U.S. Indicia

If an account is not identified as: (1) a U.S. account in Step 1; (2) a non-U.S. account in Step 2; or (3) a private banking account in Step 3, the FFI must determine whether any of the information associated with the account includes any U.S. indicia. Specific U.S. indicia include:

(1) Identification of an account holder as a U.S. resident or U.S. citizen;

(2) A U.S. place of birth for an account holder;

(3) A U.S. residence address or a U.S. correspondence address (including a U.S. P.O. box);

(4) Standing instructions to transfer funds to an account maintained in the United States;

(5) An ''in care of'' address or ''hold mail'' address that is the sole address shown in the FFI's electronically searchable information; or

(6) A power of attorney or signatory authority granted to a person with a U.S. address.

If any of the above indicia are present, the FFI is required to request certain documentation to establish whether the account is in fact a U.S. account. Notably, an FFI is only required to search electronic databases for this information.

Step 4 remains unchanged from the prior procedures in Notice 2010-60, other than the removal of a ''P.O. box'' address from the same category as an ''in care of'' or ''hold mail'' address. Notice 2011-34 explains that this change was made as the result of comments that questioned whether it was appropriate to treat a non-U.S. P.O. box as an indication of U.S. status in light of the fact that, in certain countries, a significant percentage of the population uses P.O. boxes as their sole address. However, Step 4 procedures retain a U.S. P.O. box as an indicia of U.S. status. Note that Step 4 of the private banking account procedures incorporates the same P.O. box rules.

Step 5: Accounts of $500,000 or More

In the case of any account that was not identified in the prior steps that had a balance or value of $500,000 or more at the end of the year preceding the effective date of the FFIA, the FFI must perform a ''diligent review'' of the account files associated with the account. This type of review presumably requires more than a search of electronic databases, unlike the search required in Step 4. To the extent that the account files contain any of the U.S. indicia described in Step 4, the FFI must obtain the appropriate documentation (as indicated in Step 4(B)) within two years of the effective date of the FFIA. Account holders that do not provide appropriate documentation by the required date will be classified as recalcitrant account holders until the date on which appropriate documentation is received from the account holder by the FFI.

Step 6: Annual Retesting

Beginning in the third year following the effective date of the FFIA, the FFI will be required to apply Step 5 annually to all pre-existing individual accounts that did not previously satisfy the account balance or value threshold amount to be treated as high-value accounts.

Certification

In addition to the steps outlined above, Notice 2011-34 provides a new certification requirement. The chief compliance officer of an FFI must certify to the IRS: (1) when the FFI has completed the identification procedures; (2) that the FFI did not engage in any activity directing, encouraging, or assisting account holders with respect to strategies on avoiding identification of their accounts as U.S. accounts; and (3) that the FFI has in place written policies and procedures prohibiting its employees from advising U.S. account holders on how to avoid having their U.S. accounts identified. Steps 1–3 must be certified within one year after the effective date of the FFIA, while Steps 4–5 must be certified within two years after the effective date of the FFIA.

These new certification requirements apparently were included because of the questionable business practices employed by certain non-U.S. banks that have been the target of the Department of Justice, and obviously are designed to forestall such business practices.

Long-Term Recalcitrant Account Holders

Despite the detailed guidance provided with respect to the identification of U.S. accounts, Notice 2011-34

[34] *Id.*

[35] Notice 2011-34, §I.A.2, Step 3.B.

[36] *Id.* §1.A.2, Step 3.A.iii.a. For example, a child born in the United States to diplomats stationed in the U.S. does not acquire U.S. citizenship like a child born to nondiplomatic parents does.

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does not offer any additional guidance with respect to long-term recalcitrant account holders. However, it does provide that FFIs should not view Notice 2010-60, which provided relief for FFIs that otherwise would not be able to collect the information required to comply with their obligations, as a permanent substitute for collecting and reporting information with respect to U.S. accounts.

Passthru Payments

Notice 2011-34 provides much-needed guidance with respect to ''passthru payments,'' an area that Notice 2010-60 did not address. Section 1471(d)(7) defines the term ''passthru payment'' as ''any withholdable payment or other payment to the extent attributable to a withholdable payment.'' Under §1471(a), a withholding agent is required to withhold 30% of any passthru payment made to a non-participating FFI (Non-PFFI). However, it was not clear from the definition how the concept would be applied.

Some commentators suggested a definition that would have narrowed the application to only those payments that are either withholdable payments or directly traceable to withholdable payments. Notice 2011-34 explains that this approach would not be consistent with the underlying purpose of the passthru payment rule, which is to encourage FFIs to enter into FFIAs if they hold investments that produce payments that are attributable to withholdable payments, even if an FFI does not directly hold an investment asset that produces a withholdable payment. Without a broad passthru payment rule, non-FFIs could use participating FFIs (PFFIs) as FATCA blockers. Moreover, Notice 2011-34 observed that a tracing rule would be complicated due to the diversity of capital structures and FFI payment arrangements and, therefore, not easy to administer.

Apparently, the passthru payment rule originated during the legislative process as a result of the concerns of various FFIs that saw this as both a compliance issue vis-á-vis recalcitrant account holders and a competitive issue with respect to other FFIs that could ''draft'' behind a PFFI (similar to a bicycle racer). Thus, without a passthru payment rule, the PFFI would incur the costs and burdens of being a PFFI while the ''drafting'' Non-PFFI would enjoy the benefits provided by the ''blocker'' FFI without bearing any of the costs and burdens. From a compliance perspective, the account holders of the Non-PFFI would not be subject to the FATCA reporting and withholding regime; consequently, FATCA would be circumvented.

The reach of the passthru payment is truly astounding and is the concept in the FATCA statute that makes the provision extraterritorial. For example, if an FFI determines it does not want to participate, or cannot under local law, the FFI could make the very significant financial decision not to invest in the U.S. capital markets, as it is the payment of U.S.-source income and gains that triggers the application of the FATCA provisions. However, because of the passthru payment rule, an FFI could be removed from the payment of U.S.-source income or gain by two or more other FFIs between it and the U.S. payor and still be subject to FATCA withholding. There is little escape even if an FFI no longer has U.S. customers. As long as one FFI in another FFI's payment chain receives U.S.-source income or gain, the nonparticipating FFI will still be subject to the withholding provisions to the extent of the passthru payment percentage of the other FFIs in its chain.

Notice 2011-34 provides that a payment made by an FFI will be a passthru payment to the extent of: (1) the amount of the payment that is a withholdable payment (i.e., the amount payable to an account holder that is directly traceable to a withholdable payment made to the FFI); plus (2) the amount of the payment that is not a withholdable payment, multiplied by (A) in the case of a custodial payment, the ''passthru payment percentage'' of the entity that issued the interest or instrument or (B) in the case of any other payment, the passthru payment percentage of the payor FFI.[37] Importantly, an exemption is provided for payments made under obligations grandfathered under §501(d)(2) of the HIRE Act.

Although Notice 2011-34 provides an expansive definition of the term ''passthru payment,'' it is not clear that the definition will not be scaled back in the proposed regulations. In public remarks, Michael Plowgian said the notice is ''extraordinarily broad'' in that it refers to payments without really defining them, and noted that future guidance will provide some carve-outs for some types of payments. Commentators have recommended that the definition be limited to investment-type payments, which Plowgian indicated is worth consideration with the caveat that to carve out bank deposit interest payments would be contrary to the purpose of the statute.[38]

Notice 2011-34 provides that the passthru payment percentage of a payor FFI is determined by dividing: (1) the sum of the FFI's U.S. assets held on each of the most recent four quarterly testing dates; by (2) the sum of the FFI's total assets held on those dates.[39] Alternatively, an FFI may elect to compute its passthru payment percentage to be used for the first quarter of the first year of its FFIA based on the FFI's assets on a single testing date.

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[37] *Id.* §II.A.

[38] Plowgian BNA Remarks.

[39] Notice 2001-34, §II.B.

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A "U.S. asset" is any asset to the extent that it is of a type that could give rise to a passthru payment. However, a debt or equity interest of an FFI in a domestic corporation will be treated solely as a U.S. asset. Conversely, a debt or equity interest in a non-financial foreign entity (NFFE) will be treated as solely a non-U.S. asset, notwithstanding that such an asset could give rise to a passthru payment. A U.S. asset also includes interests in non-custodial accounts held with another FFI. In that case, the value of the interest in the lower-tier FFI or the account is multiplied by the passthru payment percentage of the lower-tier FFI.

A PFFI or DCFFI that does not calculate its passthru payment percentage is deemed to have a percentage of 100%. This rule was obviously designed to encourage a PFFI to determine its passthru payment percentage, which undoubtedly would be lower than the deemed 100%.

An FFI that is not either a PFFI or a DCFFI is presumed to have a passthru payment percentage of zero. This rule reflects the fact that a non-participating or a non-deemed-compliant FFI will be subject to withholding under §1471(a). Under FATCA, withholding occurs only once; there is no cascading effect.

Example of Calculation of Passthru Payment Percentage

Notice 2011-34 provides an example to demonstrate how the passthru rules will apply. In that example, Fund A, a PFFI, is a fund of funds that elects the book value method for valuing its assets. Such assets total $100 million and include the following:

- A $20 million interest in Fund B, a Non-PFFI;
- A $30 million interest in Fund C, a PFFI, the passthru payment percentage of which is 50%;
- A $10 million interest in Fund D, an FFI that does not calculate its passthru payment percentage; and
- A $40 million interest in Fund E, a domestic corporation.

Fund A's passthru payment percentage is 65%, i.e., $65 million ($0 + $15 million + $10 million + $40 million)/$100 million. The $20 million interest in Fund B is treated as a U.S. asset and is assigned a passthru payment percentage of zero because Fund B is a Non-PFFI; the $30 million interest in Fund C is multiplied by 50%, Fund C's passthru payment percentage, which yields a value of $15 million; Fund D does not calculate its passthru payment percentage and is therefore assigned a passthru payment percentage of 100%; and Fund E is a U.S. entity so the entire $40 million interest is a U.S. asset.

Notice 2011-34 does not provide guidance on how the passthru rules apply to a partnership or other flow-through entity, and comments have been requested. Comments are also requested regarding possible exemptions from the definition of passthru payments that would be consistent with the policy goals of the passthru payment rules and reasonable in light of the potential burden on FFIs.

Deemed-Compliant FFIs

Notice 2011-34 provides three new categories DCFFIs. Previously, Notice 2010-60 announced that certain categories of FFIs will be deemed compliant with FATCA. These DCFFIs will not be subject to withholding on payments made to them, but may have to withhold on passthru payments if made to a Non-PFFI. Furthermore, a DCFFI would not be required to enter into an FFIA. A DCFFI, however, will have to apply to the IRS for DCFFI status, certify to the IRS every three years that it meets the applicable DCFFI requirements, and obtain an FFI-EIN.[40]

The three new categories of DCFFIs are as follows.

Local Banks (Same Country Exception)

This category includes an affiliated group of FFIs if: (1) each FFI in the group is licensed and regulated as a bank in its country of organization and is not an FFI as described in §1471(d)(5)(C); (2) each member of the group is organized in the same country; (3) no member maintains operations or solicits account holders outside its country of organization; and (4) each member implements policies and procedures to ensure that it does not open or maintain accounts for nonresidents, Non-PFFIs, or NFFEs (other than excepted NFFEs that are organized and operate in the same jurisdiction of the group members).[41]

Significantly, no member of the group is required to be a PFFI; in other words, every member of the affiliated group may be a DCFFI as long as the foregoing requirements are met.

Local FFI Members of PFFI Groups

This category appears to have been crafted to meet the requests of some FFIs that wish to segregate their U.S. customers into one or two affiliates so that the other affiliates may be treated as deemed-compliant without the need to enter into an FFIA.

To qualify for this category, unlike the local same-country bank exception, at least one FFI member must be a PFFI.[42] Similar to the local bank rules, the FFI members that are not PFFIs must operate only in their country of organization and may not solicit account holders outside its country of organization. The Non-

[40] *Id.* §III.
[41] *Id.* §II.A.
[42] *Id.* §II.B.

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PFFIs, however, must follow the pre-existing account and customer identification procedures required of PFFIs to identify U.S. accounts, Non-PFFI accounts, and NFFE accounts (other than excepted NFFEs that are organized and operating in the jurisdiction in which the FFI maintains the account). If any account is identified as a U.S. account, the Non-PFFI must enter into an FFIA, transfer the account to the PFFI, or close the account.

Qualifying Investment Vehicles

This category applies to certain collective investment vehicles and other investment funds. For an investment vehicle to be treated as deemed-compliant, the investment vehicle must meet the following three requirements:[43]

- All direct holders of interests in the fund are either PFFIs or DCFFIs that hold the interests on behalf of a foreign government, an international organization, a foreign central bank of issue, or any person identified as posing a low risk of tax evasion;
- The fund prohibits the subscription or acquisition of any interest in the fund by other than a PFFI, a DCFFI, or one of the entities described in the first requirement; and
- The fund certifies that any passthru payment percentages it calculates and publishes will be in compliance with the rules in §II of Notice 2011-53.

Publicly traded funds do not maintain financial accounts under §1471(d)(2)(C) because the statute provides an express exemption for such funds. However, those funds nonetheless will be required to enter into an FFIA and withhold on passthru payments made to Non-PFFIs. Moreover, such funds will be required to publish a passthru payment percentage. However, the IRS and Treasury are considering whether such funds could be treated as DCFFIs, which would simplify the compliance requirements to which they are subject.

Reporting on U.S. Accounts

Notice 2011-34 significantly simplifies the reporting that will be required on U.S. accounts and requires reporting only of year-end account balances or values. Notice 2010-60 had suggested that the highest of the month-end balances of an account during the year would be required to be reported, presumably patterned after the FBAR reporting requirement, which requires that the highest account balance during the year be reported. Commentators had indicated that this type of information generally is not kept by FFIs and to collect this information would require the development of costly computer systems. Although §1471(c)(1)(D) requires that gross receipts and gross withdrawals or payments made to and from U.S. accounts must be reported, it also provides regulatory authority to alter those reporting requirements.

Under the new reporting provisions, only the following amounts are required to be reported:

- The gross amount of dividends paid or credited to the account;
- The gross amount of interest paid or credited to the account;
- Other income paid or credited to the account; and
- Gross proceeds from the sale or redemption of property paid or credited to the account with respect to which the FFI acted as custodian, broker, nominee, or agent for the account holder.

Qualified Intermediaries

All FFIs that are currently Qualified Intermediaries (''QIs'') for purposes of §1441 must also become PFFIs in order to maintain their QI status, unless they qualify as DCFFIs.

Affiliated Group Rules

The affiliated group rules will require each FFI affiliate in an ''FFI Group'' to be a PFFI or a DCFFI. This rule may present a hardship for those FFI Groups that have a member that is resident in a jurisdiction that would not permit the reporting of information about a resident account holder, assuming that the conflict-of-law issue is not resolved with every country. It may be possible to cure the issue by applying for DCFFI status for the group as discussed above.

WHERE ARE WE NOW?

Notice 2011-53 provides much needed phased-in implementation of the FATCA reporting and withholding requirements. It also confirms that, despite all of the implementation issues, the IRS and Treasury are fully committed to FATCA's implementation despite criticism of its long-arm or extraterritoriality approach.

Based upon Notice 2011-53's statement that proposed regulations will be issued that incorporate the guidance provided in Notices 2010-60 and 2011-34, it would appear that the account due diligence procedures as modified will be adopted. Prior to this announcement, the language of the Notices and the

[43] *Id.* §III.C.

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amendments seemed to signal flexibility; however, this no longer appears to be the case.

For the immediate future, it would appear that no further guidance will be issued until proposed regulations are promulgated. For some industries, such as the insurance and funds industries, much is still unknown. The existing guidance is bank-centric and does not easily translate to other than depository accounts in all cases. For example, while the expansion of the statutory $50,000 depository account *de minimis* exception to nondepository accounts is helpful, it is not clear how that applies to insurance contracts for which there are alternative measurements.

A significant hurdle remains with foreign law data protection acts. Although talks with foreign governments apparently are taking place, to date nothing is known of what solutions might be adopted. For countries with which the United States has an income tax treaty or a Tax Information Exchange Agreement (''TIEA''), there is some promise that the reporting requirements could be satisfied by an exchange of information through those mechanisms. However, no solution has been offered for countries with which the United States does not have such treaties or agreements. Perhaps these countries will be encouraged to enter into TIEAs if there is no other option for their banks and other financial institutions to invest in the United States.

Looking back at the FATCA road traveled thus far, it is clear that much progress has been made on the part of FFIs both and the U.S. government. However, there remains a significant journey.

APPENDIX A
Implementation of FATCA Requirements

Execution of FFI Agreements	
Date on which the IRS will begin accepting applications to enter into FFI Agreements.	January 1, 2013
Last date to enter into an FFI Agreement to ensure that there is no withholding beginning on January 1, 2014. The effective date of all FFI Agreements entered into before July 1, 2013, will be July 1, 2013. FFI Agreements entered into after June 30, 2013, may not forestall withholding beginning on January 1, 2014.	June 30, 2013

Due Diligence	
New Accounts	**Transition Date Under Notice 2011-53**
Participating FFIs must implement account opening procedures described in Notice 2010-60 to identify U.S. accounts.	On or after the effective date of the FFIA

Pre-Existing Accounts	**Transition Date Under Notice 2011-53**
Large Private Banking Accounts. Completion of Step 3 (Notice 2011-34) due diligence for private bank accounts with balances or values *greater than or equal to* $500,000.	Within one year of the effective date of the FFIA
Smaller Private Banking Accounts. Completion of private banking procedures for pre-existing private bank accounts with balances or values *less than* $500,000.	Later of December 31, 2014, *or* one year after the effective date of the FFIA
All Other Pre-Existing Accounts. Completion of due diligence procedures in Notices 2010-60 and 2011-34.	Two years after the effective date of the FFIA

Reporting of U.S. Accounts	
New Accounts, Documented U.S. Accounts, and Private Banking Accounts	**Transition Date Under 2011-53**

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Limited Reporting for First Year: This limited reporting also applies to FFIs that elect to report as a U.S. FFI under §1471(c)(2) • Name, address, and U.S. TIN of each U.S. person who is an account holder or, if the account is owned by a U.S.-owned foreign entity, name, address, and U.S. TIN of each substantial U.S. owner; • The account balance as of December 31, 2013, or, for closed accounts, the balance immediately before closure; and • The account number. May elect to report under Notice 2011-34. Must report any recalcitrant account holders.	Form W-9 received by June 30, 2014, must be reported to IRS by September 30, 2014
Post-2013 Years Reporting in accordance with Notice 2011-34 as implemented in future regulations.	

Withholding	
Types of Withholdable Payments	**Transition Date Under Notice 2011-53**
U.S.-Source FDAP Payments (e.g., interest, dividends, royalties, rent, etc.).	Payments made on or after January 1, 2014
Gross Proceeds (i.e., gross proceeds from the sale of assets that produce or may produce U.S.-source FDAP income).	Payments made on or after January 1, 2015
Passthru Payments. Note that a U.S.-source FDAP payment that also would be a passthru payment is subject to the January 1, 2014, effective date.	Payments made on or after January 1, 2015

Other	
Expiring QI, WFP, and WFT Agreements	**Transition Date Under Notice 2011-53**
Original expiration date of December 31, 2012	Automatic extension until December 31, 2013

APPENDIX B

New Due Diligence Rules for Pre-Existing Individual Accounts

Step 3A: Private Banking Accounts

- FFI must ensure that all private banking relationship managers:
  - Identify U.S. persons and request a Form W-9 from each.
  - Perform a diligent review of all files for each client and identify each who has one or more of the following U.S. indicia:
    - •• U.S. citizenship or green card status;
    - •• A U.S. birthplace;
    - •• A U.S. residence address or a U.S. correspondence address, including a P.O. box (non-U.S. P.O. box no longer an indicium)
    - •• Standing instructions to transfer funds to an account maintained in the United States, or directions regularly received from a U.S. address;
    - •• An "in care of" address or a "hold mail" address that is the sole address with respect to the client; or
    - •• A power of attorney or signatory authority granted to a person with a U.S. address
- FFI must ensure that all private banking relationship managers:
  - •• For clients identified above, request documentation to establish whether the accounts are U.S. accounts (e.g., each client identified as a U.S. citizen or holding a green card must be requested to provide a Form W-9).
  - •• Treat all accounts associated with a client as U.S. accounts if the client is identified as a U.S. person, or is identified as having U.S. indicia;
  - •• Create and retain lists of all existing clients whose accounts are U.S. accounts, non-U.S. accounts, or recalcitrant accounts.

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Step 3B: Private Banking Accounts

- After the procedures in Step 3A are completed, if a manager becomes aware of an account holder of a pre-existing private banking account that has any of the U.S. indicia, he or she must:
  - Request the documentation listed under Step 3A; and
  - If the account holder does not establish non-U.S. status within one year after the manager discovers the U.S. indicia, include the account in the FFI's reporting of its U.S. accounts or treat the account as a recalcitrant account.

Step 3C: Private Banking Accounts

- Reporting: FFIs must include accounts meeting the following requirements:
  - Accounts identified in Step 3A;
  - The account holders of the accounts identified in Step 3A have provided a Form W-9; and
  - The account holders have waived applicable restrictions on information reporting to the IRS.
- Recalcitrant Accounts: FFIs are required to treat accounts that meet the following conditions as recalcitrant:
  - Accounts for which the holder has not provided the required documentation;
  - In the case of U.S. persons, the holder has not agreed to waive the applicable restrictions on information reporting to the IRS.

Step 4: Accounts with U.S. Indicia

- If an account is not identified in any of the three previous steps, the FFI must determine whether any of the information associated with the account includes any U.S. indicia, including:
  - Identification of an account holder as a U.S. resident or U.S. citizen;
  - A U.S. place of birth for an account holder;
  - A U.S. residence address or a U.S. correspondence address, including a U.S. P.O. box;
  - Standing instructions to transfer funds to an account maintained in the United States;
  - An "in care of" address or "hold mail" address that is the sole address shown in the FFI's electronically searchable information; or
  - A power of attorney or signatory authority granted to a person with a U.S. address.
- If any of the above is present, the FFI is required to request certain documentation to determine whether the account is a U.S. account.

Step 5: Accounts of $500,000 or More

- For accounts that are not identified in any of the previous steps and had a balance or value of $500,000 or more the year before the effective date of the FFI Agreement, the FFI must:
  - Perform a diligent review of the account files associated with the account.
  - Perform more than just an electronic files search.

Step 6: Annual Retesting

- Beginning in the third year following the effective date of the FFI Agreement, the FFI will be required to apply Step 5 annually to all pre-existing individual accounts that did not previously satisfy the account balance or value threshold to be treated as high-value accounts.
  - Note that this means pre-existing accounts that were excepted under the $50,000 rule for depository and non-depository accounts do not need to be retested.
  - However, because a knowledge or reason-to-know standard applies, a change of address to a U.S. address would require an inquiry.

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