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# SUMMARY OF THE PROPOSED FATCA REGULATIONS

March 7, 2012

# Introduction

In March 2010, Congress enacted Sections 1471 through 1474 of the Internal Revenue Code of 1986, as amended (the "**Code**") as an enforcement measure to prevent U.S. persons from using offshore accounts to evade U.S. federal income tax. These provisions, which are commonly referred to as "**FATCA**," impose a 30% U.S. withholding tax on "withholdable payments" made to a foreign entity unless that entity complies with specified requirements or otherwise qualifies for an exemption. Separate rules apply to "**foreign financial institutions**" (or "**FFIs**") and to "**non-financial foreign entities**" (or "**NFFEs**"), with FFIs generally being subject to a much higher compliance burden in order to avoid the imposition of the FATCA tax. An FFI will be subject to the FATCA tax unless it either qualifies for an exemption or becomes a "**participating FFI**" (or "**PFFI**") by entering into an agreement with Treasury (an "**FFI Agreement**") pursuant to which it agrees to perform certain due diligence, reporting and withholding functions. Pursuant to its FFI Agreement, a PFFI will be required to obtain and report certain information with respect to "financial accounts" held by "specified U.S. persons" or "U.S.-owned foreign entities" ("**U.S. accounts**"). In addition, it will be required to withhold FATCA tax from defined categories of payments that it makes to "recalcitrant account holders" and to certain FFIs that have not entered into FFI Agreements ("**non-participating FFIs**").

Treasury and the IRS outlined their plans for implementation of FATCA in three notices issued over the past two years (the "**Notices**").[1] Numerous commentators pointed out problematic aspects of the preliminary guidance and the FATCA regime in general.

On February 8, 2012, Treasury released proposed regulations interpreting the FATCA rules. The proposed regulations are broadly consistent with the approach set out in the Notices, but include significant modifications and refinements. Perhaps most significantly, the proposed regulations would extend various deadlines for implementing aspects of the FATCA regime. In addition, they address a number of issues that the Notices did not address. Despite the attempts of Treasury and the IRS to mitigate some of the burdens imposed by the FATCA regime, the breadth and complexity of the identification and reporting requirements contained in the proposed regulations will pose significant challenges for many foreign entities and withholding agents.

This memorandum provides a general overview of the proposed FATCA regulations. Part I gives some background and summarizes certain highlights of the proposed regulations. It also describes a joint statement from Treasury and certain major European countries that outlines a proposed intergovernmental approach to implementing FATCA. Part II lists important effective dates. Part III describes the types of payments that may be subject to the FATCA tax. Part IV discusses the definition of a "foreign financial institution" and the obligations to which a participating FFI will be subject. Part V addresses the application of FATCA to non-financial foreign entities. Parts VI and VII describe the withholding and reporting obligations, respectively, of withholding agents under FATCA. Part VIII addresses credits and refunds of the FATCA tax, and Part IX describes rules for coordinating FATCA with other withholding regimes. Appendix A provides a brief summary of the rules governing the non-FATCA U.S. withholding tax that is imposed on certain U.S.-source investment income of foreign persons. Appendix B contains an index of the defined terms used in this memorandum.

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[1] *See* Notice 2011-53, 2011-32 I.R.B. 124; Notice 2011-34, 2011-1 C.B. 765; Notice 2010-60, 2010-2 C.B. 329.

The proposed regulations are not currently effective, and the preamble does not state that withholding agents and foreign entities may rely on them pending the date of their adoption in final form. In particular, see the discussion of this point in Part II with respect to the various proposed effective dates.

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# I. Background and Highlights

## A. Background

Congress enacted FATCA so that the IRS could obtain information about offshore investments by U.S. persons and thereby better deter tax evasion. The FATCA tax gives the IRS leverage for eliciting information from foreign entities about offshore investments by U.S. persons: those foreign entities that do not provide the requisite information will be subject to the FATCA tax.

Apart from FATCA, foreign entities are subject to (i) U.S. withholding tax on certain types of U.S.-source income that is not effectively connected with the conduct of a trade or business in the United States (the "**non-FATCA withholding tax**") and (ii) regular U.S. federal income tax (and, in the case of foreign corporations, possibly also U.S. branch profits tax) on income that is "effectively connected" with the conduct of a trade or business in the United States. The proposed regulations seek to coordinate the FATCA regime with the current system of self-certification, withholding and reporting under the rules governing the non-FATCA withholding tax (the "**non-FATCA withholding rules**"). They prescribe procedures that are based on the corresponding provisions of the non-FATCA withholding rules and adopt an approach intended to reduce duplication of the administrative burden and the amount of withholding.

Like the non-FATCA withholding rules, the proposed regulations address the treatment of foreign entities that receive payments as custodians, brokers, nominees or otherwise in the capacity of agents acting on behalf of other persons ("**intermediaries**"), as well as the treatment of foreign partnerships, simple trusts and grantor trusts ("**flow-through entities**"). Under the non-FATCA withholding rules, a foreign intermediary that meets certain requirements may enter into an agreement with the IRS under which it becomes a "**qualified intermediary**" (or "**QI**"). A QI may either (i) assume primary withholding responsibility for non-FATCA withholding tax, in which case it will not be subject to non-FATCA withholding tax on payments it receives (such a QI, a "**Withholding QI**") or (ii) provide withholding agents with a certification as to the various rates of non-FATCA withholding tax applicable to the payments it receives on behalf of other persons, but not with information identifying those persons (such a QI, a "**Non-Withholding QI**"). Similarly, a foreign partnership may become a "**withholding foreign partnership**" and a foreign simple or grantor trust may become a "**withholding foreign trust**" by entering into an agreement with the IRS pursuant to which it assumes primary withholding responsibility for the non-FATCA withholding tax attributable to its partners, beneficiaries or owners.[2] A foreign intermediary that has not become a QI, or a foreign flow-through entity that has not become a withholding foreign partnership or withholding foreign trust, must provide withholding agents with specific information about the person(s) on whose behalf it is acting, or about its partners, beneficiaries or owners, as the case may be, in order to qualify for any reduction of the rate of non-FATCA withholding tax, either pursuant to the Code or pursuant to a treaty. The proposed regulations address the application of the FATCA rules to the various categories of foreign intermediaries and flow-through entities.

[2] Unlike a QI, a withholding foreign partnership or withholding foreign trust must assume primary withholding responsibility and cannot elect to be subject to non-FATCA withholding tax on payments made to it.

## B. Highlights

Below are highlights from the proposed regulations, with references to parts of the memorandum that provide a more detailed discussion of these topics.

- *Effective Dates for Withholding.* The FATCA tax will apply to certain payments of U.S.-source "fixed or determinable annual or periodical" ("**FDAP**") income beginning on **January 1, 2014** and to all other "withholdable payments" beginning on **January 1, 2015**. See Part II for a more detailed description of the various effective dates under FATCA.
  - *Expanded Scope of "Grandfathered" Obligations.* No FATCA tax will apply to payments made with respect to any "obligations" that are outstanding on **January 1, 2013**. The original grandfathering date was March 18, 2012. See Part III.D.
  - *Foreign Passthru Payments.* PFFIs will not be required to withhold FATCA tax from "foreign passthru payments" (*i.e.*, payments that are treated as attributable to withholdable payments, but are not themselves withholdable payments) before **January 1, 2017**. The proposed regulations reserve on the definition of "foreign passthru payments." Prior to January 1, 2017, however, PFFIs will be required to report to the IRS payments of foreign-source FDAP income (and, possibly, certain other payments) that they make to non-participating FFIs. See Parts III.C and VII.E.
- *Entities Exempt from FATCA Tax and Deemed-Compliant FFIs.* The proposed regulations identify various types of entities that will be exempted from the FATCA tax or treated as "deemed-compliant" FFIs. For FFIs, the scope of these categories is quite narrow. For example, private equity and hedge fund entities would generally not qualify for this treatment. By contrast, as a result of these exclusions, few NFFEs are likely to be subject to the FATCA tax.
  - *Exclusions.* Entities that will be exempt from the FATCA tax include holding companies and intercompany financing companies for non-financial groups, certain bankrupt and start-up entities, NFFEs that are publicly traded corporations and NFFEs that are engaged in active businesses. See Parts IV.B.1, IV.B.3 and V.
  - *Deemed-Compliant FFIs.* Deemed-compliant FFIs will not be required to enter into FFI Agreements in order to avoid the FATCA tax. These entities include certain investment vehicles, "local" banks, pension funds and charitable organizations. Some of these FFIs will be required to register with the IRS and comply with certain procedural requirements, while others will be permitted simply to certify their status as deemed-compliant FFIs to withholding agents. See Part IV.B.2.
- *Transitional Rules for Affiliated Groups of FFIs.* An FFI will generally not be permitted to be a PFFI unless all of its branches are FATCA-compliant and every other FFI with which it is affiliated is either a PFFI or a deemed-compliant FFI. The proposed regulations provide that until **January 1, 2016**, an FFI may become a PFFI even if it has branches or affiliates that are not FATCA-compliant, provided that those branches or affiliates (i) are subject to laws that prohibit various aspects of FATCA compliance and (ii) agree to comply with certain due diligence and other requirements. During the transition period, withholding agents will be required to treat the relevant branches or affiliates as non-participating FFIs. See Part IV.C.5.
- *Narrowed Definition of "Financial Account."* A PFFI is required to obtain and report certain information with respect to "financial accounts" that are treated as U.S. accounts. A "financial account" does not include an equity or debt interest in a PFFI that is regularly traded on an established securities market. The proposed regulations further narrow the definition of "financial account" to exclude non-regularly traded debt or equity interests in any FFI that is not an

investment vehicle, unless the value of the interest is determined primarily by reference to assets that give rise to "withholdable payments." See Part IV.D.1.

- *Due Diligence and Reporting Requirements of PFFIs.* The proposed regulations provide guidance with respect to the various requirements that will apply to PFFIs, including the obligation to identify and report U.S. accounts. Significant additional aspects of PFFIs' obligations will be addressed in FFI Agreements.
    - *Procedures for Identifying U.S. Accounts.* The proposed regulations outline in detail the due diligence that PFFIs will be required to undertake to identify their U.S. accounts. These requirements rely in significant respects on PFFIs' existing procedures, including those required by "know your customer" and anti-money-laundering ("**AML**") rules, and include provisions intended to minimize the administrative burden relating to pre-existing accounts. In general, no due diligence will be required for pre-existing accounts with values up to $250,000 (if maintained for entities) or up to $50,000 (if maintained for individuals). With respect to pre-existing accounts maintained for individuals outside the United States with values up to $1 million, a PFFI will be permitted to rely primarily on electronically searchable information. Despite these exceptions and special rules, identifying U.S. accounts and obtaining certifications or other documentation with respect to the account holders is likely to be time-consuming and expensive for PFFIs. See Part IV.C.1.
    - *Phased-in Reporting by PFFIs.* The reporting obligations of PFFIs with respect to U.S. accounts will be phased in. With respect to 2013 and 2014, PFFIs will be required to report only the account number, identifying information about the account holders (and, in the case of account holders that are foreign entities, certain of their U.S. owners) and the value of the account. Reporting on income payable to U.S. accounts will begin with respect to 2015, while full reporting, including reporting on all gross proceeds, will begin with respect to 2016. See Part IV.C.2.
- *Withholding and Reporting Obligations.* Generally speaking, the proposed regulations attempt to harmonize the obligations of withholding agents under FATCA with the corresponding requirements of the non-FATCA withholding rules. Persons receiving withholdable payments will generally certify their FATCA status to withholding agents on IRS Form W-9 or W-8, but certain exceptions and special rules apply, particularly in the case of pre-existing accounts and obligations. For certain purposes, withholding agents will be permitted to rely on information gathered in the course of AML due diligence. Payments to certain intermediaries and flow-through entities (generally including payments of U.S.-source FDAP income to PFFIs that are intermediaries or flow-through entities) will be treated as made to the persons on whose behalf the intermediary is acting or the partners, beneficiaries or owners of the flow-through entity, as the case may be. The proposed regulations require withholding agents to file Forms 1042 and 1042-S with the IRS (and send copies of Form 1042-S to "recipients") reporting payments subject to the FATCA tax (regardless of whether the FATCA tax is actually imposed). See Part VII.

## C. Topical Roadmap

Part II of this memorandum, which summarizes important effective dates, and Part III, which discusses the scope of payments that will be subject to FATCA withholding, are topics of general interest. Other parts of this memorandum may be of particular interest to certain entities, as described below:

- **Withholding agents**, especially U.S. financial institutions, will find a discussion of the FATCA withholding rules in Part VI, and a discussion of the FATCA reporting obligations of withholding agents in Part VII. In addition, Part IX describes how a withholding agent's obligations under

FATCA will be coordinated with its withholding and reporting obligations under the non-FATCA withholding rules.

- **Foreign financial institutions**, including foreign investment entities such as hedge funds and private equity funds, will find in Part IV a discussion of the definition of an FFI, the exemptions applicable to certain FFIs, the obligations of a PFFI and the procedure for becoming a PFFI. In particular, Part IV.C describes certain provisions that will be contained in FFI Agreements, including aspects of the due diligence that PFFIs must undertake to identify U.S. accounts.
- **Non-financial foreign entities** will find in Part V a discussion of the withholding rules applicable to payments to NFFEs, including a description of the types of NFFEs that will be exempt from the FATCA tax.
- **Publicly traded entities** may, depending on their status, be interested in Part IV.D.1(i) (exclusion of publicly traded equity or debt from the definition of "financial account") and/or Part V (exemption from FATCA tax for NFFEs that are publicly traded corporations and their affiliates).
- **Foreign intermediaries (*i.e.*, entities acting as agents for others) and flow-through entities (*i.e.*, partnerships, simple trusts and grantor trusts)** will find a description of the application of the certification, withholding and reporting requirements to them in Parts IV.C.3, VI and VII.

## D. Proposed Intergovernmental Approach

In addition to publishing the proposed FATCA regulations, Treasury has issued a joint statement with France, Germany, Italy, Spain and the United Kingdom announcing a plan to pursue government-to-government agreements as an alternative to regular FATCA compliance for FFIs in those countries. The proposed intergovernmental approach is intended to remove certain legal impediments to FATCA compliance, and reduce the anticipated financial burdens of such compliance, for FFIs in the participating countries. Treasury has stated that it is in discussions with many other jurisdictions about such agreements.

Under the framework outlined in the joint statement, any country participating in the intergovernmental arrangement (a "**partner country**") would enact legislation requiring FFIs in the partner country to collect information about U.S. accounts and report it to their local tax authorities. The government of the partner country would then transmit this information to the United States. FFIs in partner countries would not be required to enter into FFI Agreements, although certain of them would be required to register with the IRS. They would also not be required to terminate the account of any "recalcitrant account holder" or to withhold FATCA tax from payments to recalcitrant account holders or to FFIs organized in partner countries.[3] Payments to any FFI in a partner country would be exempt from FATCA tax. Negotiating agreements with partner countries may be a time-consuming process, so it is not clear whether any of these agreements will be in place prior to January 1, 2014, when withholding under FATCA will commence.

In the joint statement, Treasury also announced that the United States is willing to adopt reciprocal rules pursuant to which U.S. financial institutions would be required to collect information on accounts maintained for residents of partner countries and report that information to the U.S. government, which would transmit it to the government of the relevant partner country. These rules could impose meaningful new due diligence and reporting obligations on U.S. financial institutions.

[3] The joint release does not address the treatment of payments by FFIs in partner countries to non-participating FFIs in countries that are not partner countries.

## II. Effective Dates

In Notice 2011-53, Treasury and the IRS announced their intention to defer the date on which withholding would commence under the FATCA regime to January 1, 2014, in the case of withholdable payments of U.S.-source FDAP income, and otherwise to January 1, 2015.[4] Under a statutory grandfathering rule, the FATCA tax would not have been imposed on any payment made pursuant to, or the gross proceeds from any disposition of, an "obligation" outstanding on March 18, 2012.

The proposed regulations provide for certain further extensions of effective dates. As noted above, the proposed regulations are not currently effective, and the preamble does not state that they may be relied upon prior to the date of their adoption in final form. Therefore, the extensions are not yet binding on the government, although we anticipate that Treasury and the IRS will formally adopt these effective dates, perhaps prior to finalizing the proposed regulations.

Under the proposed regulations:

- The FATCA tax would not apply to any payment made pursuant to, or the gross proceeds from any disposition of, an "obligation" outstanding on **January 1, 2013** or to any "foreign passthru payment" (described below) that was attributable to any such payment.[5]
- Withholdable payments of U.S.-source FDAP income (i) to *prima facie* FFIs[6] and (ii) in respect of accounts or obligations not in existence as of January 1, 2013 would be subject to the FATCA tax as of **January 1, 2014**.
- The FATCA tax would apply to all other withholdable payments as of **January 1, 2015**.
- "Foreign passthru payments" (*i.e.*, payments made by PFFIs that are treated as attributable to withholdable payments, but are not themselves withholdable payments, such as interest on bank accounts maintained by PFFIs and distributions to shareholders by corporate PFFIs) would be subject to the FATCA tax no earlier than **January 1, 2017**. The proposed regulations reserve on the precise definition of, and the rules applicable to withholding on, foreign passthru payments. For 2015 and 2016, however, PFFIs would generally be required to report to the IRS payments of foreign-source FDAP income (and, possibly, certain other payments) that they make to non-participating FFIs.
- The obligation of a PFFI to report information with respect to U.S. accounts would be phased in as follows:
    - for calendar years 2013 and 2014, a PFFI would be required to report only the account number; the name, address and U.S. tax identifying number ("**TIN**") of each U.S. account holder and, in the case of account holders that are foreign entities, certain U.S. owners of the account holder; and the value of the account;
    - for calendar year 2015, a PFFI would be required to report the foregoing information and payments made with respect to the account *other than* gross proceeds from the sale or redemption of property with respect to which the PFFI acted as a broker or other type of agent for the account holder; and

[4] Prior to the issuance of Notice 2011-53, the FATCA regime would generally have become effective on January 1, 2013.

[5] See Part III.D for a discussion of what constitutes an "obligation" for this purpose.

[6] For a definition of "*prima facie*" FFI, see Part IV.C.1(i).

  - full reporting, including reporting on all gross proceeds, would begin with respect to calendar year 2016.
- A PFFI that is reporting with respect to 2013 (the first year for which reports are due) would generally be required to report any U.S. accounts and accounts held by recalcitrant account holders that it had identified as of **June 30, 2014**. In general, the report for 2013 would be due by **September 30, 2014**.

The preamble to the proposed regulations states that Treasury and the IRS intend to publish a draft model FFI Agreement in early 2012 and a final model FFI Agreement in the fall of 2012. Treasury and the IRS previously announced that an FFI will be required to enter into an FFI Agreement by **June 30, 2013** in order to ensure that it will be identified as a PFFI in sufficient time to avoid the imposition of the FATCA tax.[7] According to the preamble, the IRS will make available no later than **January 1, 2013** an online process through which an FFI will be able to register as a PFFI or registered deemed-compliant FFI.[8]

# III. Withholdable Payments and Foreign Passthru Payments

Under the proposed regulations, the FATCA tax will begin to apply to certain "withholdable payments" of U.S.-source FDAP income as of January 1, 2014 and to all other "withholdable payments" as of January 1, 2015. In addition, no earlier than January 1, 2017, a PFFI will generally be required to withhold FATCA tax from "foreign passthru payments" that it makes to "recalcitrant account holders" and non-participating FFIs.

Subject to certain exceptions, a "**withholdable payment**" is:

  - any payment of U.S.-source FDAP income; or
  - any gross proceeds from the sale or other disposition of any property of a type that can produce U.S.-source interest or dividends.

A "**foreign passthru payment**" is any other payment made by a PFFI (*e.g.*, interest on a bank account maintained by a PFFI or a distribution made by a corporate PFFI on its shares) to the extent that such payment is treated as attributable to a withholdable payment.

## A. U.S.-Source FDAP Income

The first type of withholdable payment is U.S.-source FDAP income. In general, the term "U.S.-source FDAP income" has the same meaning for purposes of the FATCA regime as it does for purposes of the non-FATCA withholding rules. Except as described below, however, payments of U.S.-source FDAP income will be subject to the FATCA tax, even if they are exempt from tax under the non-FATCA withholding rules. Thus, for example, a payment of U.S.-source portfolio interest, which is exempt from tax under the non-FATCA withholding rules, is a withholdable payment that will be subject to the FATCA tax. In addition, although interest paid on deposits by foreign branches of U.S. banks is not treated as

[7] See Notice 2011-53.

[8] For a discussion of registered deemed-compliant FFIs, see Part IV.B.2(i).

U.S.-source income for purposes of the non-FATCA withholding rules, it will be treated as a withholdable payment, for purposes of FATCA.[9]

An item of U.S.-source FDAP income will not be treated as a withholdable payment if it is effectively connected with a trade or business conducted through a permanent establishment in the United States. Certain other types of U.S.-source FDAP income will also not be treated as withholdable payments:

- payments of interest on short-term obligations that are exempt from withholding tax under the non-FATCA withholding rules;[10]
- payments of tax-exempt interest on state and local bonds;[11] and
- payments made in the ordinary course of the withholding agent's business for non-financial services, goods or the use of property.

## B. Gross Proceeds

Subject to certain exceptions, gross proceeds from the disposition after December 31, 2014 of any property of a type that can produce U.S.-source interest or dividends will constitute a withholdable payment.[12] For this purpose, it does not matter whether the seller has actually received any interest or dividends from the property. For example, gross proceeds from the sale of U.S. stock after December 31, 2014 will constitute a withholdable payment even if the issuer does not pay dividends.

Gross proceeds from the termination of a financial instrument that can produce the payment of a dividend equivalent (as defined in Section 871(m) of the Code) will be treated as a withholdable payment, provided that the termination constitutes a disposition of the financial instrument for U.S. federal income tax purposes.[13] It is not clear whether a withholding agent will be permitted to rely on certain representations by its counterparty to determine whether a particular financial instrument is one that "can" produce a dividend equivalent payment. It is also not clear whether gross proceeds from the sale of an interest in a domestic or foreign partnership that holds property of a type that can produce U.S.-source interest or dividends will be treated as a withholdable payment.

The proposed regulations reserve on the issue of how a withholding agent that is a flow-through entity will determine the amount of gross proceeds allocable to each of its partners, beneficiaries or owners for purposes of withholding the FATCA tax. Treasury and the IRS have requested comments regarding potential rules that are administratively feasible and that do not provide an incentive for investing in U.S. assets through flow-through entities, rather than directly.

[9] As discussed in Part IX, a withholding agent that withholds the FATCA tax from a payment of U.S.-source FDAP income will be entitled to credit that withholding against its liability to withhold non-FATCA withholding tax from the payment.

[10] For this purpose, a short-term obligation is any obligation that is payable no more than 183 days after its issue date.

[11] The proposed regulations do not address these payments, but the preamble states that they will not constitute withholdable payments because they are excluded from gross income under Section 103 of the Code.

[12] Neither a constructive sale under Section 1259 of the Code nor a marking to market under Section 475 or 1296 of the Code will be treated as a disposition for purposes of the FATCA regime.

[13] If the proceeds include a dividend equivalent, however, the dividend equivalent will be treated as U.S.-source FDAP income (subject to FATCA withholding on or after January 1, 2014) and only the balance of the proceeds will be treated as gross proceeds (subject to FATCA withholding on or after January 1, 2015).

Withholdable payments will not include gross proceeds from the disposition of:

- property that would produce interest or dividends that are excluded from the definition of “withholdable payment;” and
- certain fractional shares of stock.

## C. Foreign Passthru Payments

To the extent that a payment other than a withholdable payment is “attributable to” a withholdable payment, it will constitute a foreign passthru payment. Thus, for example, a portion of interest paid by a foreign bank on its depository accounts, or a portion of a distribution a corporate foreign investment vehicle makes to its shareholders, could potentially be treated as a foreign passthru payment. The proposed regulations reserve on the precise definition of, and the rules applicable to withholding on, foreign passthru payments. As discussed above, a PFFI will not be required to withhold FATCA tax from foreign passthru payments before January 1, 2017. In order to deter non-participating FFIs from using PFFIs as FATCA “blockers” prior to 2017, the proposed regulations require PFFIs to report to the IRS payments of foreign-source FDAP income (and, possibly, certain other payments) that they make to non-participating FFIs in 2015 and 2016.[14]

Under a controversial approach proposed in Notice 2011-34, the extent to which any payment made by a PFFI (other than in its capacity as a custodian or other agent) would be treated as a foreign passthru payment would be determined by reference to the percentage of the PFFI’s assets that constitute “U.S. assets,” rather than by tracing the payment to withholdable payments that the PFFI has received.[15] The reservation on foreign passthru payments in the proposed regulations may indicate that Treasury and the IRS are rethinking the framework set forth in Notice 2011-34.

## D. Grandfathered Obligations

The proposed regulations provide that payments made under, and proceeds from the disposition of, an obligation that is outstanding on January 1, 2013 will not constitute withholdable payments or foreign passthru payments and will therefore not be subject to the FATCA tax. This definition of grandfathered obligations represents an extension of the original grandfathering date, which was March 18, 2012.

In general, the term “obligation” means any legal agreement that produces or could produce any withholdable payment or foreign passthru payment other than:

- agreements or instruments that are treated as equity for U.S. federal income tax purposes;
- agreements that lack a stated expiration date or term, such as savings deposits or demand deposits;
- brokerage, custodial or other similar agreements to hold financial assets for the account of others; and
- master agreements that merely set forth general and standard terms and conditions that are intended to apply to a series of transactions.

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[14] See Part VII.E.

[15] Treasury and the IRS explained in the Notice that they had rejected a direct tracing approach because they had concluded that such a rule would permit PFFIs to be used as “blockers” through which non-participating FFIs could benefit indirectly from investments in U.S. assets.

Thus, an ISDA Master Agreement would not by itself constitute an obligation for this purpose, but an ISDA Master Agreement together with a particular confirmation would. A binding agreement to extend credit for a fixed term (*e.g.*, a line of credit or a revolving credit facility) will constitute an obligation, provided that the agreement fixes the material terms under which the credit will be provided, including a stated maturity date. A life insurance contract payable upon the earlier of a stated age or death will also constitute an obligation for this purpose.

In general, an obligation that is not a debt instrument will be considered outstanding on January 1, 2013 if the relevant agreement was executed before January 1, 2013. A debt obligation will be considered outstanding on January 1, 2013 if it has an issue date before January 1, 2013.[16] Any material modification of an outstanding obligation will result in the obligation's being treated as executed (or, in the case of a debt obligation, newly issued) as of the effective date of the modification.

# IV. Section 1471: Application of FATCA to Foreign Financial Institutions

Section 1471 provides for the imposition of the FATCA tax on any withholdable payment or foreign passthru payment made to an FFI unless the FFI is a participating FFI or qualifies for an exemption. This part discusses the provisions in the proposed regulations relating to the definition of an FFI, the exemptions applicable to certain FFIs and the obligations of a PFFI. In addition, it describes certain provisions that will apply to an FFI that is a member of an affiliated group of entities that includes one or more other FFIs. For this purpose, an affiliated group generally means one or more chains of entities affiliated with a common parent if the common parent owns, directly or indirectly, more than 50% of the voting power and value of each other group member that is a corporation and one or more members of the group own, directly or indirectly, more than 50% of the value of each other group member that is a partnership or other non-corporate entity (an "**Affiliated Group**").

## A. Foreign Financial Institutions Generally

An FFI is a "financial institution" that is not a U.S. person for U.S. federal income tax purposes. In general, a "financial institution" is:

- an entity that accepts deposits in the ordinary course of a banking or similar business;
- an entity that holds financial assets for the account of others as a substantial portion of its business;
- an entity engaged (or holding itself out as being engaged) primarily in investing, reinvesting or trading in securities, partnership interests, commodities, notional principal contracts, insurance or annuity contracts or any interest (including futures, forward contracts or options) in any of these types of assets (any such entity, if foreign, a "**Foreign Investment Entity**"); or

[16] It thus appears that debt instruments issued in a "reopening" on or after January 1, 2013 of instruments originally issued before January 1, 2013 will be treated as grandfathered obligations if they are treated for U.S. federal income tax purposes as having the same "issue date" as the debt instruments that were issued before January 1, 2013 (*e.g.*, because the reopening constitutes a "qualified reopening"). By contrast, it appears that if a reopening does not permit the subsequently issued instruments to have the same "issue date" as the original instruments, debt instruments issued in the reopening will not be treated as grandfathered obligations. If reopened debt and original debt are not treated the same for FATCA purposes (even if otherwise fungible for tax purposes, *e.g.*, because neither is treated as having been issued with original issue discount), this may necessitate different identification (*e.g.*, "CUSIP" or "ISIN") numbers or have other adverse consequences.

- an insurance company that issues, or is obligated to make payments with respect to, any cash value insurance contract, annuity contract or other "financial account" or the holding company of such an insurance company (any such entity, if foreign, an "**Insurance FFI**"). The definition of "financial institution" does not include an insurance company the business of which consists solely of issuing contracts without cash value.

#### 1. Banking or Similar Business

An entity will be considered to be engaged in a banking or similar business if, in the ordinary course of its business with customers, it engages in one or more of the following activities: (i) accepting deposits; (ii) making loans; (iii) purchasing, selling, discounting or negotiating accounts receivable, checks or other evidences of indebtedness; (iv) issuing, and negotiating drafts drawn under, letters of credit; (v) providing trust or fiduciary services; (vi) financing foreign exchange transactions; (vii) entering into, purchasing or disposing of finance leases or leased assets; or (viii) providing charge and credit card services. Whether an entity is subject to the banking and credit laws of any jurisdiction will be a relevant consideration, but will not be determinative of whether the entity is engaged in a banking or similar business.

#### 2. Holding Financial Assets for the Account of Others

An entity will be treated as holding financial assets for the account of others as a substantial portion of its business if its gross income attributable to holding financial assets for the account of others and related financial services constitutes at least 20% of its entire gross income during the three-year period ending on December 31 of the year in which the determination is made (or, if shorter, the period during which the entity has been in existence). Whether an entity is subject to the banking and credit, broker-dealer, fiduciary or similar laws of any jurisdiction will be a relevant consideration, but will not be determinative of whether the entity is engaged in holding financial assets for the account of others.

#### 3. Investment Entity

An entity will be considered to be engaged primarily in the business of investing, reinvesting or trading the types of investment assets described above if its gross income attributable to such activities constitutes at least 50% of its entire gross income during the three-year period ending on December 31 of the year in which the determination is made (or, if shorter, the period during which the entity has been in existence).

### B. Excluded Entities, Deemed-Compliant Entities and Low-Risk Entities

The proposed regulations provide for three special classes of entities: (i) entities that are excluded from the definition of "financial institution" ("**Excluded Entities**"); (ii) "deemed-compliant" FFIs, which are not required to enter into FFI Agreements in order to avoid the FATCA tax; and (iii) entities that are exempt from the FATCA tax because Treasury and the IRS have determined that they pose a low risk of tax evasion ("**Exempt Beneficial Owners**"). These categories are quite narrow, and most FFIs will not qualify for one of them. For example, although certain types of Foreign Investment Entities may be deemed-compliant FFIs, private equity and hedge fund entities will generally not qualify for this treatment. In Notice 2011-34, Treasury and the IRS stated that they were considering the circumstances under which certain FFIs with regularly traded interests, such as exchange-traded funds, could be treated as deemed-compliant FFIs. The proposed regulations do not provide any such treatment for regularly traded Foreign Investment Entities.

### 1. Excluded Entities

The proposed regulations provide that the following types of entities will be excluded from the definition of "financial institution" and will therefore constitute non-financial foreign entities. Moreover, these Excluded Entities will also be "excepted NFFEs" exempt from the FATCA tax imposed under Section 1472.[17]

- *Certain Holding Companies*. An entity substantially all of the activities of which involve owning all or a portion of the stock of one or more subsidiaries that engage in trades or businesses, provided that no such subsidiary is a "financial institution."
  - *Investment Funds Do Not Qualify*: An entity will not qualify for this exception if it functions, or holds itself out, as an investment fund the purpose of which is to acquire or fund companies and then hold interests in those companies as investments.
- *Certain Start-Up Entities.* An entity that is not yet operating a business and has no prior operating history, but is investing capital with the intent to operate a non-financial business. This exception expires 24 months after the initial organization of the entity.
  - *Investment Funds Do Not Qualify*: An entity will not qualify for this exception if it functions, or holds itself out, as an investment fund, as described above.
- *Non-Financial Entities Liquidating or Emerging from Reorganization or Bankruptcy.* An entity that was not a financial institution during the preceding five years and is in the process of liquidating its assets or is reorganizing with the intent to continue or recommence operations as a non-financial entity.
- *Hedging/Financing Centers of Non-Financial Groups.* An entity that primarily engages in financing and hedging transactions with or for members of its Affiliated Group that are not financial institutions, provided that the Affiliated Group is primarily engaged in a non-financial business and that the relevant entity does not provide financing or hedging services to non-affiliates.
- *Section 501(c) Entities.* A foreign entity that is described in Section 501(c) of the Code.[18]

### 2. Deemed-Compliant FFIs

Certain types of FFIs will be treated as "**deemed-compliant FFIs**," which will not be required to enter into FFI Agreements in order to avoid the FATCA tax. Deemed-compliant FFIs will be treated as FFIs and will therefore not be NFFEs subject to the FATCA tax under Section 1472. The proposed regulations delineate three categories of deemed-compliant FFIs: (i) registered deemed-compliant FFIs, (ii) certified deemed-compliant FFIs and (iii) owner-documented FFIs.

(i) Registered Deemed-Compliant FFIs.

In general, an FFI of one of the types listed below may become a "**registered deemed-compliant FFI**" if it registers with the IRS and meets certain procedural requirements.[19] In general, only the following types of FFIs may qualify as registered deemed-compliant FFIs:

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[17] See Part V.

[18] The difference between this type of Excluded Entity and a non-profit organization, which will be treated as a certified deemed-compliant FFI, as discussed in Part IV.B.2(ii), is not entirely clear. It may be that, to qualify as an Excluded Entity, an organization must have received a determination letter from the IRS as to its status under Section 501(c) of the Code.

- *Local FFIs.* A bank or similar deposit-taking organization, a securities broker or dealer or a financial planner or investment advisor that, in each case, is licensed and regulated under the laws of its country of organization and limits its activities to that country, if the entity meets certain requirements intended to ensure that it does not directly or indirectly maintain accounts for Specified U.S. Persons.[20] An entity can qualify for this treatment only if (i) its country of organization is "**FATF-compliant**" (that is, the country meets certain standards set by the Financial Action Task Force, an inter-governmental body that develops and promotes international policies to combat money laundering and terrorist financing) and (ii) in the case of an entity that is a member of an Affiliated Group, each member of the Affiliated Group is organized in the same country and also qualifies for this treatment.
  - *Investment Funds Do Not Qualify.* An entity will not qualify for this treatment if it is an FFI solely because it is a Foreign Investment Entity.
- *Non-Reporting Members of Affiliated Groups.* An FFI that is a member of an Affiliated Group that includes one or more PFFIs if the entity meets certain requirements intended to ensure that it does not directly or indirectly maintain accounts for Specified U.S. Persons.
- *Qualified Collective Investment Vehicles.* An entity that is an FFI solely because it is a Foreign Investment Entity if:
  - it is regulated as an investment fund in its country of organization;
  - each holder of record of its equity interests, each holder of record of its direct debt interests in excess of $50,000 and each other holder of a financial account it maintains is a PFFI, a registered deemed-compliant FFI, an Exempt Beneficial Owner or a U.S. person (other than a Specified U.S. Person); and
  - all other FFIs in its Affiliated Group (if any) are either PFFIs or registered deemed-compliant FFIs.

  For example, a foreign mutual fund might be described in this category if all interests in the fund are held by clearing organizations that are PFFIs.
- *Restricted Funds.* An entity that is an FFI solely because it is a Foreign Investment Entity if:
  - it is regulated as an investment fund in its country of organization, which must be a FATF-compliant country;
  - interests in it are sold only through certain distribution channels (*e.g.*, through distributors that are PFFIs) and are not offered to U.S. persons, non-participating FFIs or certain types of NFFEs;
  - it complies with certain other requirements intended to ensure that it does not directly or indirectly maintain accounts for Specified U.S. Persons; and
  - all other FFIs in its Affiliated Group (if any) are either PFFIs or registered deemed-compliant FFIs.

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(*cont.*)

[19] Pursuant to these requirements, the FFI must, *inter alia*, (i) have its chief compliance officer, or an individual of equivalent standing, certify to the IRS that the FFI has satisfied all of the requirements for its specific deemed-compliant category as of the date it registers and (ii) renew this certification every three years.

[20] The term "Specified U.S. Person" is defined in Part IV.D.2.

(ii) Certified Deemed-Compliant FFIs

The following types of entities will be treated as deemed-compliant FFIs, provided that they properly certify their status as such to a withholding agent. A "**certified deemed-compliant FFI**" will not be required to register with the IRS.

- *Non-registering Local Bank.* An FFI that operates and is licensed solely as a bank in its country of organization and that engages primarily in the business of making loans and taking deposits only in that country, if the FFI meets certain other requirements, including that it have no more than $175 million in assets on its balance sheet and that its Affiliated Group (if any) have no more than $500 million in assets on its balance sheet and consist only of non-registering local banks organized in the same country.
- *Retirement Funds.* An FFI that is organized for the provision of retirement or pension benefits if it meets one of two alternative sets of requirements.
- *Non-Profit Organizations.* An FFI that (i) is established and maintained exclusively for religious, charitable, scientific, artistic, cultural or educational purposes; (ii) is exempt from income tax in its country of residence; and (iii) meets certain other requirements generally intended to ensure that its assets and income do not inure to the benefit of private persons.
- *Low-Value Accounts.* An FFI that is not a Foreign Investment Entity or Insurance FFI if (i) no financial account maintained by the FFI or its Affiliated Group has a value in excess of $50,000 and (ii) the Affiliated Group had no more than $50 million in assets on its balance sheet as of the end of its most recent accounting year.

(iii) Owner-Documented FFIs

The third category of deemed-compliant FFI, "**owner-documented FFIs**," consists of certain Foreign Investment Entities. Certain family investment vehicles may fit into this category. Most hedge funds will not, however, because of the requirement that an owner-documented FFI not issue debt, other than regularly traded debt, in excess of $50,000. In addition, the exception would not be available to an investment fund that is likely to receive payments from a withholding agent that is not a financial institution.

An entity that is an FFI solely because it is a Foreign Investment Entity and that meets the requirements outlined below will be treated as an owner-documented FFI with respect to payments received from a withholding agent that is either a U.S. financial institution or a PFFI, provided that the withholding agent agrees to undertake specified due diligence and reporting obligations. An owner-documented FFI will generally be required to submit to each cooperating withholding agent, on an annual basis, a reporting statement that contains certain information about every person that owns an equity interest in the FFI, as well as certifications or other documentation identifying the FATCA status of each such person and any waivers required by FATCA. The withholding agent, in turn, must report this information to the IRS.

In order to qualify as an owner-documented deemed-compliant FFI, a Foreign Investment Entity must *not*:

- be affiliated with any FFI other than an entity that is an FFI solely because it is a Foreign Investment Entity;
- maintain a financial account for any non-participating FFI; or
- issue debt (other than debt that is regularly traded on an established securities market) to any person in excess of $50,000.[21]

[21] For the definition of what is regularly traded on an established securities market, see Part IV.D.1(i).

An owner-documented FFI will not be treated as a deemed-compliant FFI with respect to any payment or account for which it acts as an intermediary.

### 3. Exempt Beneficial Owners

The following types of FFIs will be Exempt Beneficial Owners, which will be exempt from the FATCA tax in respect of payments they receive as beneficial owners (but not in respect of payments they receive as intermediaries):

- foreign governments and their political subdivisions and wholly owned instrumentalities and agencies;
- international organizations and their wholly owned instrumentalities and agencies;
- foreign central banks of issue;
- governments of U.S. possessions;
- certain foreign retirement funds;[22] and
- Foreign Investment Entities that are wholly owned by one or more other Exempt Beneficial Owners.

## C. FFI Agreements

An FFI that is neither a deemed-compliant FFI nor an Exempt Beneficial Owner will be required to enter into an FFI Agreement with the IRS, and thereby become a PFFI, in order to avoid the imposition of the FATCA tax on withholdable payments and foreign passthru payments it receives. The preamble to the proposed regulations states that an FFI that is a QI, withholding foreign partnership or withholding foreign trust will be required to become a PFFI in order to retain its status as such. It also states that the IRS intends to amend the withholding agreements of QIs, withholding foreign partnerships and withholding foreign trusts in order to incorporate the requirements applicable to PFFIs.

Section 1471(b) of the Code provides that an FFI Agreement will require a PFFI to:

- obtain information from holders of the financial accounts it maintains to permit it to determine which of those accounts are U.S. accounts;
- comply with such verification and due diligence procedures as Treasury may require;
- report to Treasury on an annual basis certain information with respect to each U.S. account it maintains;
- withhold FATCA tax from withholdable payments and foreign passthru payments that it makes to recalcitrant account holders and non-participating FFIs;
- withhold FATCA tax from the portion of withholdable payments that it makes to certain PFFIs that is allocable to accounts maintained by such PFFIs for recalcitrant account holders or foreign financial institutions;
- comply with requests from Treasury for additional information with respect to any U.S. accounts it maintains; and

[22] A retirement fund will be an Exempt Beneficial Owner if it meets either of two sets of requirements. One of these sets of requirements, it appears, may also qualify the retirement fund as a certified deemed-compliant FFI.

- attempt to obtain a waiver from each holder of a U.S. account of any foreign law that would otherwise prevent the reporting required by FATCA and, if such a waiver is not obtained, close the account.

The proposed regulations provide details with respect to various of these requirements and, in some circumstances, modify the requirements.

Each PFFI and registered deemed-compliant FFI will receive a special EIN (an "**FFI-EIN**"). The IRS will create an online FFI account for each PFFI and registered deemed-compliant FFI, and it is contemplated that PFFIs will be able to make annual certifications, and otherwise manage their account information, through their online accounts.

### 1. Identification and Documentation of Account Holders

The proposed regulations describe procedures that a PFFI will be required to follow pursuant to its FFI Agreement in order to determine which of the accounts it maintains are U.S. accounts, accounts held by recalcitrant account holders or accounts held by non-participating FFIs.[23] If a PFFI does not obtain the required evidence of the account holder's FATCA status within a specified time period, the account holder will be treated as:

- a non-participating FFI, in the case of an entity; or
- a recalcitrant account holder, in the case of an individual.

A detailed description of these procedures is beyond the scope of this memorandum.

Part VI.C provides a brief overview of the rules under which a withholding agent must determine the status of a "payee" for purposes of FATCA. For withholding agents, the principal method of payee identification will be the collection of certifications from payees, generally on **IRS Form W-9** or **W-8**, as updated to include information relevant to the determination of the payee's status for purposes of FATCA. In certain circumstances, a withholding agent will be permitted to rely on documentary evidence other than Form W-9 or W-8 to establish the FATCA status of a payee. In general, the same procedures and standards of knowledge will apply to a PFFI's determination of the FATCA status of an account holder, but PFFIs will benefit from significant exceptions and modifications to these requirements.

Both the proposed rules generally applicable to withholding agents and the proposed rules applicable to the due diligence obligations of PFFIs contain provisions that are intended to reduce the administrative burden of compliance with the FATCA regime. In particular, a more liberal due diligence standard generally applies to accounts that a PFFI maintained prior to the effective date of its FFI Agreement ("**pre-existing accounts**"). Modified rules also apply in certain circumstances to accounts that the PFFI maintains outside the United States ("**offshore accounts**"). Notably, for purposes of a PFFI's identification of U.S. accounts:

- certain pre-existing accounts with values under a stated threshold amount will be exempt from the due diligence requirements; and
- in the case of a pre-existing offshore account maintained for an individual that has a value of no more than **$1 million**, a PFFI will be permitted to rely primarily on electronic searches (as opposed to the manual review generally required by the due diligence procedures).

[23] For a discussion of the definition of "U.S. account," see Part IV.D. For a discussion of the definition of "recalcitrant account holder," see Part IV.E.

Despite the transition rules and the other modified due diligence rules (such as permitting PFFIs to rely for certain purposes on information that they have collected pursuant to AML requirements), the process of identifying, and collecting the appropriate certifications and other documentation with respect to, U.S. accounts is likely to be burdensome, time-consuming and expensive for PFFIs.

The proposed regulations set forth separate due diligence procedures for accounts held by entities ("**entity accounts**") and accounts held by individuals ("**individual accounts**"). The most significant aspects of the proposed due diligence requirements for pre-existing accounts are summarized below. For new accounts, a PFFI must generally obtain FATCA-related certifications from the account holders. In addition, a PFFI will be required to review all information it collects with respect to an individual account, including information collected for non-FATCA regulatory purposes, to determine whether the account holder has any U.S. indicia, such as a U.S. place of birth or passport. The proposed regulations contain a list of U.S. indicia for this purpose.

(i) Entity Accounts

*Timeline.* Unless an exception applies, a PFFI must complete its due diligence with respect to pre-existing entity accounts:

- within **one year** of the effective date of its FFI Agreement, in the case of any account holder that is a *prima facie* FFI; and
- otherwise, within **two years** of the effective date of its FFI Agreement.

In general, an account holder is a "***prima facie*** **FFI**" if the PFFI has available as a part of its electronically searchable information (i) an indication that the account holder is an intermediary for purposes of the non-FATCA withholding rules or (ii) for an account maintained in the United States, a standardized industry code that indicates that the account holder is a financial institution.

*Exception to Due Diligence Requirements.* At the election of a PFFI, the PFFI will generally not be required to conduct due diligence with respect to a pre-existing entity account if, as of the effective date of its FFI Agreement:

- the account is an offshore account; and
- the value of the account (plus the value of other accounts that the PFFI and any members of its Affiliated Group maintain for the account holder) does not exceed **$250,000**.[24]

A PFFI will not be required to treat the holder of an account of this type as a non-participating FFI, regardless of whether the PFFI performs FATCA-related due diligence with respect to the account. An account that meets this test will continue to qualify for the due diligence exception until the account value exceeds $1 million at the end of any subsequent calendar year.

(ii) Individual Accounts

PFFIs generally must collect a Form W-9 or W-8 from each individual account holder, although they will be permitted to obtain certain other documentary evidence in lieu of a Form W-8 for offshore accounts.

[24] The account balance test will be applied (i) by taking into account other accounts only to the extent that the PFFI's computerized systems link the accounts by reference to a data element, such as a client number or TIN, and (ii) by aggregating all accounts (including accounts held by individuals) that any "relationship manager" knows, or has reason to know are controlled (other than in a fiduciary capacity) by the account holder.

*Timeline.* Unless an exception applies, a PFFI must complete its due diligence with respect to pre-existing individual accounts:

- within **one year** of the effective date of its FFI Agreement, in the case of any High-Value Account, as defined below; and
- otherwise, within **two years** of the effective date of its FFI Agreement.

*Alternative Procedures for Low-Value Pre-Existing Offshore Accounts.* Except in the case of High-Value Accounts, as defined below, the due diligence procedures are significantly modified in the case of pre-existing offshore accounts maintained for individuals. For these accounts, the PFFI may conduct electronic searches, rather than a manual review of the account files. The PFFI will be required to conduct the regular due diligence and certification procedures, including obtaining additional documentation from the pre-existing account holder, only if its electronically searchable information with respect to the account holder includes any U.S. indicia, such as a U.S. place of birth or passport. If a PFFI does not locate any U.S. indicia for an account holder through the electronic search, it will not be attributed knowledge of any information contained in files that it was not required to, and did not, review. Thus, for example, the PFFI would not be treated as having reason to know that the account holder was a U.S. person, even if it had on file a copy of the account holder's passport showing the United States as the place of birth, provided that the PFFI was not required to, and did not, review that file.

*Enhanced Review for High-Value Accounts.* Notice 2011-34 outlined enhanced review requirements for private banking accounts. In response to comments, the proposed regulations do not incorporate these requirements, but instead prescribe an enhanced review procedure for High-Value Accounts. A "**High-Value Account**" is any pre-existing individual account that the PFFI has not previously identified as a U.S. account, if the value of the account (plus the value of other accounts that the PFFI and any members of its Affiliated Group maintain for the account holder) exceeds $1 million at the end of the most recent preceding calendar year.[25]

*Exceptions to Due Diligence Requirements.* At the election of a PFFI, the PFFI will generally not be required to conduct due diligence with respect to a pre-existing individual account if, as of the effective date its FFI Agreement, the value of the account (plus the value of other accounts that the PFFI and any members of its Affiliated Group maintain for the account holder) does not exceed:

- **$50,000**, in the case of an account other than a cash value insurance or annuity contract; or
- **$250,000**, in the case of a cash value insurance or annuity contract.[26]

A PFFI will not be required to treat the holder of an account of this type as a recalcitrant account holder, regardless of whether the PFFI performs FATCA-related due diligence with respect to the account. An account that meets this test will continue to qualify for the due diligence exception until the account value exceeds $1 million at the end of any subsequent calendar year. In addition, a PFFI will not be required to conduct due diligence with respect to any Excluded Depository Account, even if it has documentary evidence that the account holder is a Specified U.S. Person.[27]

[25] See note 24 for the rules with respect to the application of the account balance test.

[26] See note 24 for the rules with respect to the application of the account balance test.

[27] The term "Excluded Depository Account" is defined in Part IV.D.4. The term "Specified U.S. Person" is defined in Part IV.D.2.

(iii) Certifications

In order for a PFFI to comply with its FFI Agreement, a responsible officer of the PFFI must make the following certifications to the IRS:

- within **one year** of the effective date of the FFI Agreement, a certification that:
  - the PFFI has completed the review of all High-Value Accounts; and
  - to the best of the officer's knowledge, after a reasonable inquiry, the PFFI did not have any formal or informal practices or procedures in place from August 6, 2011 through the date of the certification to assist account holders in the avoidance of FATCA (*e.g.*, by instructing account holders to split up accounts to avoid classification as a High-Value Account); and
- within **two years** of the effective date of the FFI Agreement, a certification that:
  - the PFFI has completed the relevant account identification procedures and documentation requirements for all pre-existing accounts; or
  - if the PFFI has not obtained the required documentation for any pre-existing account, it is treating the relevant account in the manner required by its FFI Agreement.

### 2. Account Reporting

Pursuant to its FFI Agreement, a PFFI will be required to report information about U.S. accounts and recalcitrant account holders to the IRS annually, beginning with respect to 2013. The proposed regulations outline the rules that will generally apply, including the dates as of which PFFIs must commence their reporting.[28]

In addition to these reporting requirements, a PFFI that acts as a withholding agent with respect to any withholdable payment or foreign passthru payment will generally be subject to the reporting requirements applicable to withholding agents under FATCA. See Part VII for a description of those requirements and their application to PFFIs.

(i) Reporting U.S. Accounts

For each calendar year, a PFFI will be required to report certain information with respect to each account that is held by a Specified U.S. Person or an NFFE that is a U.S.-Owned Foreign Entity.[29] A PFFI is not required to report with respect to any account it maintains for another PFFI, even if the other PFFI holds the account as an intermediary.

Except as discussed below, the information that a PFFI must report with respect to these accounts will include:

- the name, address and TIN of each account holder that is a Specified U.S. Person or U.S.-Owned Foreign Entity and, in the case of an account holder that is a U.S.-Owned Foreign Entity, of each Substantial U.S. Owner of the entity;[30]

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[28] In the case of reporting with respect to U.S. accounts, the proposed regulations reserve on the application of the requirements to PFFIs that are QIs, withholding foreign partnerships or withholding foreign trusts. As noted above, the preamble states that these entities' withholding agreements with the IRS under the non-FATCA withholding rules will be amended to incorporate the requirements applicable to PFFIs.

[29] The term "Specified U.S. Person" is defined in Part IV.D.2. The term "U.S.-Owned Foreign Entity" is defined in Part IV.D.3.

[30] The term "Substantial U.S. Owner" is defined in Part IV.D.3

- the account value as of the end of the calendar year (or immediately before the closure of the account); and
- the payments made with respect to the account during the calendar year.

The proposed regulations detail these reporting requirements, including the manner in which a PFFI will determine account values and the amounts and character of payments made with respect to accounts.

In general, in lieu of reporting information under the rules described above, a PFFI may elect to provide reports for any calendar year on IRS Form 1099 as if the PFFI were a U.S. person and each Specified U.S. Person and U.S.-Owned Foreign Entity were an individual and a citizen of the United States.[31] In addition to the information otherwise required to be reported on Form 1099, the electing PFFI will be required to report certain FATCA-related information. A PFFI may revoke this election for any subsequent calendar year without the consent of the IRS.

(ii) Reporting Recalcitrant Account Holders

In general, for each calendar year, a PFFI will be required to report the aggregate number, and aggregate value, of accounts held by recalcitrant account holders. The report will specify the portion of these accounts attributable to recalcitrant account holders that have U.S. indicia.

(iii) Phasing in of Reporting Obligations

The proposed regulations provide that, at the election of the PFFI, the reporting requirements for U.S. accounts will be phased in. For each year, beginning with 2013, PFFIs will be required to report, with respect to each U.S. account, (i) the account number; (ii) identifying information about the account holder and, in the case of any account holder that is a U.S.-Owned Foreign Entity, its Substantial U.S. Owners and (iii) the value of the account. Under the phase-in rules, a PFFI may elect to report:

- **with respect to 2013 and 2014**, only this information; and
- **with respect to 2015**, this information and payments made with respect to the account *other than* gross proceeds from sales or redemptions of property with respect to which the PFFI acted as a broker or other type of agent for the account holder.[32]

Thus, if a PFFI so elects, full reporting, including reporting of all payments of gross proceeds, will commence with the reports filed for 2016. This election will be available regardless of whether the PFFI elects to provide reports on Form 1099. There is no phase-in of the requirement to report information about recalcitrant account holders; this requirement will apply in full for all years, beginning with 2013.

A PFFI must generally file its reports with respect to U.S. accounts and recalcitrant account holders on or before the March 31 following the relevant calendar year. With respect to 2013, however, a PFFI must generally report by **September 30, 2014** all accounts that it has identified as either U.S. accounts or accounts held by recalcitrant account holders as of **June 30, 2014**.[33]

(iv) Special Reporting Rule for Foreign Reportable Amounts

Except as otherwise provided in the proposed regulations or in its FFI Agreement, a PFFI will be required to file returns on Forms 1042 and 1042-S reporting withholdable payments and foreign passthru

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[31] This election will not apply to cash value insurance or annuity contracts.

[32] Although it is not entirely clear, it is possible that this exclusion does not apply to all payments of gross proceeds that a PFFI may make to an account holder during 2015.

[33] It is not clear whether the reporting encompasses accounts in existence as of June 30, 2014 that were opened after December 31, 2013.

payments for which it is a withholding agent.[34] A PFFI will not be required to withhold the FATCA tax from foreign passthru payments before January 1, 2017, and the proposed regulations reserve on the definition of "foreign passthru payment." A PFFI will, however, be required to file Forms 1042 and 1042-S with respect to payments of "foreign reportable amounts" that it makes to non-participating FFIs in 2015 and 2016. For a discussion of these reporting requirements, see Part VII.E.

### 3. Withholding

Except as discussed below, a PFFI will be required pursuant to its FFI Agreement to withhold the FATCA tax, on or after the relevant effective dates for withholding, from:

- withholdable payments and foreign passthru payments that it makes to recalcitrant account holders and non-participating FFIs; and
- the portion of any withholdable payment of U.S.-source FDAP income that it makes to a Non-Withholding QI that is allocable to accounts that the Non-Withholding QI maintains for recalcitrant account holders and non-participating FFIs.[35]

A PFFI that is an intermediary (other than a Withholding QI) or flow-through entity (other than a withholding foreign partnership or withholding foreign trust) will generally be relieved of this withholding obligation with respect to any payments of U.S.-source FDAP income that it makes. Such a PFFI will generally be required to provide any withholding agent from which it receives a withholdable payment of U.S.-source FDAP income with documentation establishing the correct amount of FATCA tax to be withheld in respect of the person(s) on whose behalf the PFFI is acting (in the case of an intermediary) or the PFFI's partners, beneficiaries or owners (in the case of a flow-through entity).[36] Unless the PFFI knows, or has reason to know, that a withholding agent failed to withhold the correct amount of FATCA tax, the PFFI will not be required to withhold FATCA tax from any corresponding payments that it makes.[37] This rule is intended to reduce the instances in which over-withholding occurs because a withholding agent withholds under the non-FATCA withholding rules on a payment that is also subject to withholding by the PFFI under FATCA.

In the case of Non-Withholding QIs, this relief from withholding obligations arises pursuant to the application of Section 1471(b)(3) of the Code, which provides that a PFFI that meets any requirements specified by Treasury and the IRS may elect not to withhold FATCA tax, but instead to have FATCA tax withheld from payments it receives to the extent such payments are allocable to recalcitrant account holders or non-participating FFIs. Under the proposed regulations, a Non-Withholding QI will be required to make this election, and no other type of PFFI will be permitted to make it.[38] Moreover, this "election"

[34] For a description of these reporting requirements, see Part VII.

[35] As discussed below, a Non-Withholding QI will be required to make an election under Section 1471(b)(3) to be subject to the FATCA tax on withholdable payments of U.S.-source FDAP income.

[36] For a description of this documentation, see Part VI.C. If such a PFFI does not provide this documentation to a withholding agent, the withholding agent will be required to withhold the FATCA tax from the entire payment of U.S.-source FDAP income to the PFFI. If the withholding agent does not withhold the FATCA tax under these circumstances, it appears that the PFFI will not be relieved of its withholding obligation with respect to the corresponding payment it makes, even if it does not know, or have reason to know, that the withholding agent failed to withhold the FATCA tax.

[37] The relevant provision refers only to intermediaries other than QIs, but presumably a similar standard will apply to a Non-Withholding QI.

[38] The exemption of certain other intermediaries and flow-through entities (*i.e.*, intermediaries other than QIs and flow-through entities other than withholding foreign partnerships and withholding foreign trusts) from the obligation to withhold FATCA tax from withholdable payments of U.S.-source FDAP income arises solely pursuant to the proposed regulations and not as a consequence (*cont.*)

will apply (i) only with respect to withholdable payments of U.S.-source FDAP income and (ii) only if the withholding agent is either a PFFI or a U.S. person.[39]

### 4. Verification

An FFI Agreement will require the PFFI to (i) adopt written policies and procedures governing FATCA-related due diligence, withholding and reporting requirements and (ii) conduct periodic reviews of its compliance with these policies and procedures and its FATCA obligations generally. A responsible officer of a PFFI will be required to certify the PFFI's compliance with its FATCA obligations on a periodic basis and may be required to provide certain factual information and disclose material failures with respect to the PFFI's compliance with any of the requirements of its FFI Agreement.

If the IRS identifies concerns about a PFFI's compliance with its FFI Agreement, it may enlist an external auditor to verify compliance. FFI Agreements will not, however, require PFFIs to arrange for periodic external audits. The preamble states that Treasury and the IRS are considering, as an alternative to the external audits that are currently required under the withholding agreements with QIs, withholding foreign partnerships and withholding foreign trusts, coordinating the audit requirements for these entities with the verification procedures under FATCA.

### 5. Special Rules for Affiliated Group and Branches

In general, an FFI that is a member of an Affiliated Group will not be permitted to become a PFFI unless every other FFI in its Affiliated Group is either a PFFI or a registered deemed-compliant FFI.[40] In addition, a PFFI or registered deemed-compliant FFI must agree to all of the requirements for that status with respect to all of its branches, offices and divisions. The proposed regulations loosen these requirements during a transition period.

(i) Limited FFIs

Until January 1, 2016, an FFI may become either a PFFI or a registered deemed-compliant FFI even if it is affiliated with one or more FFIs that do not have either status, provided that those non-complying FFIs (i) maintain accounts that are subject to laws prohibiting compliance with various FATCA-related requirements (*e.g.*, reporting U.S. accounts to the IRS, withholding the FATCA tax from payments to recalcitrant account holders or closing accounts within a reasonable period of time) and (ii) agree to comply with certain due diligence and other requirements ("**Limited FFIs**"). To qualify for Limited FFI status, an FFI will be required to register as a Limited FFI as part of its Affiliated Group's FFI Agreement process and to agree that it will:

- identify its account holders under the due diligence requirements applicable to PFFIs and retain account holder documentation for six years from the effective date of its registration;[41]

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(*cont.*)

of an election under Section 1471(b)(3). The preamble states that withholding foreign partnerships and withholding foreign trusts may not make elections under Section 1471(b)(3) because, pursuant to their withholding agreements with the IRS, these entities are generally required to assume withholding responsibilities under the non-FATCA withholding rules with respect to their partners, beneficiaries or owners, and Treasury and the IRS intend to expand their responsibilities to cover FATCA withholding responsibility. The same reasoning presumably applies to Withholding QIs.

[39] If a Non-Withholding QI does not provide allocation information to a withholding agent, the withholding agent will be required to withhold the FATCA tax from the entire payment of U.S.-source FDAP income to the PFFI. A Non-Withholding QI will be required to waive any rights under a tax treaty with respect to any FATCA tax withheld from payments to it.

[40] As discussed in Part IV.B.2(i), certain members of a PFFI's Affiliated Group will be permitted to become registered deemed-compliant FFIs if they meet specified requirements.

[41] The due diligence requirements are discussed in Part IV.C.1.

- report to the IRS with respect to U.S. accounts to the extent permitted under applicable law;
- not open any U.S. accounts or accounts for non-participating FFIs, including any accounts transferred from other members of its Affiliated Group; and
- identify itself to withholding agents as a non-participating FFI.

As noted above, a QI will lose its status as a QI unless it becomes a PFFI. Under a special rule, a QI may become a Limited FFI even if none of the FFIs in its Affiliated Group can comply with the provisions of an FFI Agreement, provided that the QI otherwise meets the conditions for Limited FFI status. A QI will retain its QI status while it is a Limited FFI.

A withholding agent, including any affiliate of the Limited FFI, that makes a withholdable payment to a Limited FFI will be required to treat the Limited FFI as a non-participating FFI and therefore will generally be required to withhold FATCA tax from the payment. The proposed regulations describe situations in which a PFFI or deemed-compliant FFI will be considered to have made a withholdable payment to an affiliated Limited FFI (*e.g.*, when it receives a withholdable payment on behalf of the Limited FFI).

(ii) Limited Branches

Until January 1, 2016, an FFI that otherwise satisfies the requirements for PFFI status will be allowed to become a PFFI even if one or more of its branches cannot satisfy those requirements, provided that (i) the FFI maintains at least one branch that complies with all of the PFFI requirements (even if that branch is a U.S. branch), (ii) each non-complying branch maintains accounts that are subject to laws prohibiting compliance with various FATCA-related requirements and (iii) the FFI agrees to cause each non-complying branch comply with certain due diligence and other requirements (such non-complying branch, a "**Limited Branch**"). To obtain Limited Branch status for any of its branches, an FFI will be required to agree to the same terms with respect to the branch as would apply to a Limited FFI. Thus, the FFI will be required to agree to treat the Limited Branch as an entity separate from its other branches for withholding purposes and to cause the Limited Branch to identify itself to withholding agents as a separate, non-participating FFI.

A withholding agent, including any affiliate of the relevant PFFI, that makes a withholdable payment to a Limited Branch will be required to treat the Limited Branch as a non-participating FFI and therefore will generally be required to withhold FATCA tax from the payment. In addition, the relevant PFFI will be required to withhold on a withholdable payment when a branch other than the Limited Branch receives, or is deemed to receive, a payment on behalf of the Limited Branch.

(iii) Termination of Limited FFI/Limited Branch Status

As of **January 1, 2016**:

- a Limited FFI will cease to have that status, with the result that each PFFI and registered deemed-compliant FFI in its Affiliated Group will lose its status as such, and
- an FFI with one or more Limited Branches will cease to be a PFFI,

unless such status was previously terminated. In this regard, a Limited FFI or Limited Branch will cease to have that status as of the beginning of the third calendar quarter following the date on which it is no longer prohibited from complying with the requirements of FATCA. In such a case, each affiliated PFFI and deemed-compliant FFI of the former Limited FFI, or the PFFI with the former Limited Branch, as the case may be, will retain its status if the former Limited FFI or the PFFI with the former Limited Branch notifies the IRS that it will comply with the requirements of FATCA.

(iv) Coordinated Application and Compliance Processes

Treasury and the IRS announced in Notice 2011-34 that they intended to require affiliated FFIs to enter into their FFI Agreements pursuant to a coordinated application process under which a single FFI in the

Affiliated Group would undertake the application process on behalf of all of the affiliated FFIs. They also stated that they intended to provide affiliated FFIs with an option under which some or all of them could appoint one of the affiliated FFIs to assume an oversight role with respect to ongoing compliance with the FFI Agreements. While the proposed regulations do not address these points, the preamble states that Treasury and the IRS intend to issue further guidance regarding a coordinated application and oversight process for FFIs that are members of Affiliated Groups.

Notice 2011-34 also outlined a proposed centralized compliance option for certain investment funds that are associated with a common investment manager. Under this proposal, the investment manager would generally execute a single FFI Agreement on behalf of each fund it advises and would be responsible for the funds' compliance with their obligations under FATCA. The proposed regulations do not address this option.

## D. U.S. Accounts

In general, a U.S. account is a "financial account" maintained by an FFI that is held by one or more Specified U.S. Persons or U.S.-Owned Foreign Entities. The definitions of those terms are discussed below. For this purpose, a financial account is generally treated as held by the person listed as the holder, even if that person is a financial institution acting as a custodian or other agent for the beneficial owner.[42]

### 1. Definition of "Financial Account"

(i) In General

Subject to certain exceptions, a "financial account" is:

- any "**depository account**," defined as:
  - a commercial, checking, savings, time or thrift account;
  - an account evidenced by a certificate of deposit, thrift certificate, investment certificate, certificate of indebtedness or other similar instrument; or
  - an amount held by an insurance company under an agreement to pay or credit interest thereon;
- a custodial account, defined as an account maintained for the benefit of another person that holds any financial instrument or contract held for investment;
- an equity or debt interest, not regularly traded on an established securities market, in an entity that is an FFI solely because it is a Foreign Investment Entity;
- an equity or debt interest, not regularly traded on an established securities market, in any *other* FFI if the value of the interest is determined primarily by reference to an asset that gives rise to a withholdable payment;[43] and
- any cash value insurance contract or annuity contract.

[42] If a person other than a financial institution holds a financial account for the benefit of another person, the beneficial owner will be treated as the account holder.

[43] On its face, the term "equity or debt interest" would not appear to include "structured notes," with embedded derivatives, that are not equity of the issuer or indebtedness under common law.

The proposed regulations narrow the definition of "financial account" in an important respect by excluding non-regularly traded equity and debt interests in FFIs (other than Foreign Investment Entities) unless the interests track assets that give rise to withholdable payments. Thus, for example, privately placed debt obligations of foreign banks generally will not constitute financial accounts. However, debt obligations of Foreign Investment Entities, such as foreign hedge fund vehicles, will be financial accounts unless they are regularly traded on an established securities market.

Equity or debt interests in any FFI, including a Foreign Investment Entity, will not constitute "financial accounts" if they are regularly traded on an established securities market. The proposed regulations provide a relatively liberal definition of "regularly traded." Under the proposed regulations, debt or equity interests will be treated as regularly traded on an established securities market if (i) trades in the interests were effected, other than in *de minimis* quantities, on the market on at least 60 days during the prior calendar year and (ii) the aggregate number of interests that were traded on the market during the prior calendar year was at least 10% of the average number of interests outstanding during the prior calendar year.[44]

For this purpose, an "**established securities market**" is, for any calendar year:

- a foreign securities exchange that (i) is officially recognized, sanctioned or supervised by a governmental authority of the country in which the market is located and (ii) has an annual value of shares traded (determined as provided in the proposed regulations) that exceeds $1 billion during each of the three immediately preceding years;
- a national securities exchange that is registered with the Securities and Exchange Commission (the "**SEC**");
  - any exchange designated under a limitation-on-benefits article of an income tax treaty with the United States; or
  - any other exchange that Treasury and the IRS may designate in published guidance.

If an exchange has more than one tier or market level on which stock may be separately listed or traded, each tier will be treated as a separate exchange for this purpose. The IRS may provide in published guidance that a particular exchange does not qualify as an established securities market if (i) the exchange does not have adequate listing, financial disclosure or trading requirements or does not adequately enforce such requirements or (ii) there is no clear and convincing evidence that the exchange ensures the active trading of listed stocks.

A portion of a payment made by a PFFI on its equity or debt interests could be treated as a foreign passthru payment, even if the equity or debt interests do not constitute "financial accounts."[45] In that case, the PFFI would be required to withhold the FATCA tax from payments to holders of such equity or debt interests that were non-participating FFIs. If, for example, regularly traded debt of a PFFI were held by a clearing organization that was a non-participating FFI, a portion of the payments made by the PFFI on the debt could be subject to the FATCA tax. The proposed regulations reserve on the rules applicable to foreign passthru payments. We hope that future guidance excludes from the definition of "foreign passthru payment" any payments on equity and debt interests that are not financial accounts.

[44] For purposes of the definition of a Publicly Traded Corporation (which, as described below, will not be a Specified U.S. Person and will be an Excepted NFFE), stock will be considered to meet the applicable trading requirements for a calendar year if the stock is traded during that year on an established securities market located in the United States and is regularly quoted by dealers making a market in the stock. The definition of "financial account" does not incorporate this rule.

[45] For a discussion of foreign passthru payments, see Part III.C.

(ii) Excluded Accounts

The following accounts will be excluded from the definition of "financial account":

- certain "tax-favored" retirement and savings accounts, as well as certain savings accounts held by retirement or pension funds that are certified deemed-compliant FFIs;
- term life insurance contracts; and
- accounts held solely by one or more Exempt Beneficial Owners or by non-participating FFIs that hold the account as intermediaries solely on behalf of one or more Exempt Beneficial Owners.

### 2. Definition of "Specified U.S. Person"

(i) In General

Subject to the exceptions listed below, a "**Specified U.S. Person**" means any U.S. person, as defined for U.S. federal income tax purposes. The proposed regulations expand the statutory list of exceptions to this definition by adding dealers and brokers. Under the proposed regulations, the following persons will not be treated as Specified U.S. Persons:

- Publicly Traded Corporations, as defined below, and corporate members of the same Affiliated Group as a Publicly Traded Corporation;[46]
- organizations that are exempt from taxation under Section 501(a) of the Code;
- individual retirement plans;
- the United States or any of its wholly owned agencies or instrumentalities;
- States, the District of Columbia, possessions of the United States and their respective political subdivisions and wholly owned agencies and instrumentalities;
- banks and trust companies, subject by law to supervision and examination by state or federal banking authorities, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or exercising certain fiduciary powers;
- building and loan associations;
- real estate investment trusts;
- entities that have elected to be treated as regulated investment companies for U.S. federal income tax purposes and entities that are registered with the SEC under the Investment Company Act of 1940;
- common trust funds maintained by banks;
- charitable remainder annuity trusts, charitable remainder unitrusts and certain other charitable trusts;
- dealers in securities, commodities or derivative financial instruments (including notional principal contracts, futures, forward contracts and options), registered as such under federal or state law; and

[46] Publicly traded partnerships are not excluded from the definition of "Specified U.S. Person."

- "brokers," including an obligor that regularly issues and retires its own debt obligations or a corporation that regularly redeems its own stock.

(ii) Definition of "Publicly Traded Corporation"

A "**Publicly Traded Corporation**" is a corporation the stock of which is regularly traded on an established securities market. For this purpose, an established securities market has the meaning set forth above, and a corporation's stock will be considered to be regularly traded on an established securities market if:

- one or more classes of stock representing more than 50% of the corporation's voting power and value were listed on a market during the prior calendar year; and
- with respect to each listed class, either:
  - trades were effected, other than in *de minimis* quantities, on the market on at least 60 days during the prior calendar year and at least 10% of the average number of shares outstanding in that class during the year were traded on the market; or
  - the class was traded during the relevant year on an established securities market in the United States and was regularly quoted by dealers making a market in the stock.

### 3. Definition of "U.S.-Owned Foreign Entity"

A "**U.S.-Owned Foreign Entity**" is any foreign entity that has one or more Substantial U.S. Owners. A foreign entity may make the determination of whether it is a U.S.-Owned Foreign Entity as of the last day of its accounting year or as of the date on which it provides relevant documentation to a withholding agent.

In the case of a foreign entity other than a Foreign Investment Entity or an Insurance FFI, a "**Substantial U.S. Owner**" is a Specified U.S. Person that:

- with respect to a foreign corporation, owns directly or indirectly more than 10% of the corporation's stock (by vote or value);
- with respect to a foreign partnership, owns directly or indirectly more than 10% of the profits or capital interests in the partnership;
- with respect to a grantor trust, is treated as the owner of any portion of the trust for U.S. federal income tax purposes; or
- with respect to any other trust, holds directly or indirectly more than 10% of the beneficial interest in the trust (determined under valuation rules provided in the proposed regulations).

A Foreign Investment Entity or Insurance FFI will be treated as a U.S.-Owned Foreign Entity if a Specified U.S. Person owns ***any*** of its equity interests.

The proposed regulations provide constructive ownership rules for determining whether a Specified U.S. Person has an indirect ownership interest in a foreign entity. In general, positions owned by a corporation, partnership or trust will be treated as owned "proportionately" by that entity's shareholders, partners, owners or beneficiaries. There will be no attribution from a Publicly Traded Corporation, however, unless the corporation is a non-participating FFI. In addition, options to acquire positions will be deemed to be exercised, and there will be an anti-abuse rule.

### 4. Financial Accounts Not Treated as U.S. Accounts

Unless a PFFI elects not to have this exception apply, a U.S. account will not include any depository account held solely by one or more individuals if the value of the account (plus the value of other accounts that the PFFI and members of its Affiliated Group maintain for the account holder) does not exceed $50,000 as of the end of the relevant calendar year (an "**Excluded Depository Account**"). The

$50,000 threshold will be applied by aggregating accounts only to the extent that the PFFI's computerized systems link the accounts by reference to a data element (*e.g.*, a client number or TIN).

## E. Recalcitrant Account Holders

As discussed above, except as otherwise provided in its FFI agreement, a PFFI will be required to withhold FATCA tax from withholdable payments and foreign passthru payments to recalcitrant account holders, and to report information to the IRS with respect to accounts held by recalcitrant account holders. The proposed regulations include rules for determining when an account holder will be treated as a "recalcitrant account holder."

### 1. Definition of Recalcitrant Account Holder

In general, the holder of an account will be treated as a "**recalcitrant account holder**" if:

- the holder fails to comply with requests by the PFFI for the documentation or information that the PFFI is required to collect in order to determine whether the account is a U.S. account;
- the holder fails, upon a request from the PFFI, to provide a valid Form W-9 or a correct name and TIN combination when the PFFI has received notice from the IRS indicating that the name and TIN combination reported by the PFFI is incorrect; or
- the holder fails (or if the holder is a U.S.-Owned Foreign Entity, any of its Substantial U.S. Owners fails) to provide a valid and effective waiver of any foreign law would prevent reporting by the PFFI with respect to the account.

A holder of an Excluded Depository Account will not be treated as a recalcitrant account holder, nor will a holder of a pre-existing individual account that qualifies for one of the exemptions from the PFFI's due diligence requirements if the PFFI elects to apply that exemption.[47] In addition, an account holder will not be treated as a recalcitrant account holder if it is, or is presumed to be, an FFI; rather, under the appropriate circumstances, it will be treated as a non-participating FFI.

### 2. Timing

In general, the date on which an account holder will begin to be treated as a recalcitrant account holder will depend on the type of account, as described below:

| | |
|---|---|
| Pre-existing account other than High-Value Account | Second anniversary of the effective date of the PFFI's FFI Agreement |
| Pre-existing High-Value Account reviewed in first year of PFFI's FFI Agreement | First anniversary of the effective date of the PFFI's FFI Agreement |
| Pre-existing High-Value Account reviewed in any subsequent year | July 1 following the year at the end of which the account had a value of $1 million or more |
| Account other than a pre-existing account | 90 days after the account is opened |

[47] These exemptions are discussed in Part IV.C.1(ii). Although the proposed regulations do not address the point explicitly, it is clear that the holder of a pre-existing entity account that qualifies for an exemption from the PFFI's due diligence requirements will not be treated as a recalcitrant account holder if the PFFI elects to apply that exemption. See Part IV.C.1(i).

| | |
|---|---|
| Account (other than a pre-existing account) for which the PFFI has requested correct name and TIN combination | 90 days after the request |
| Account (including a pre-existing account) for which there has been a change in circumstances, such as the termination of an exemption from the PFFI's due diligence requirements | 90 days after the PFFI requests documentation or a waiver of applicable foreign law following such change in circumstances |

A recalcitrant account holder will cease to be treated as such when it provides the relevant information and waivers.

## V. Section 1472: Application of FATCA to Non-Financial Foreign Entities

In general, Section 1472 provides for the imposition of the FATCA tax on any withholdable payment made to an NFFE (other than an Excepted NFFE, as defined below) that is either (i) the beneficial owner of the payment or (ii) an agent acting on behalf of another NFFE that is the beneficial owner of the payment, unless:

- the beneficial owner (or its agent) either (i) certifies that the beneficial owner does not have any Substantial U.S. Owners or (ii) provides the withholding agent with the name, address and TIN of each of the beneficial owner's Substantial U.S. Owners; and
- the withholding agent reports information about the beneficial owner's Substantial U.S. Owners to the IRS.

A withholding agent that receives information regarding any Substantial U.S. Owner of an NFFE, other than an Excepted NFFE, will be required to report to the IRS, with respect to each calendar year in which it makes any withholdable payment to the NFFE, the name of the NFFE and certain information relating to each such Substantial U.S. Owner, including the name, address and TIN of each such Substantial U.S. Owner.[48] Unless the withholding agent files the report, any withholdable payment that it made to the NFFE during the relevant year will be treated as subject to the FATCA tax, and the withholding agent will be liable for the tax, plus interest and penalties.

The proposed regulations provide that certain types of NFFEs will be exempt from the FATCA tax in respect of payments that they receive as beneficial owners ("**Excepted NFFEs**"). The following entities will be Excepted NFFEs:

- Publicly Traded Corporations and corporate members of the same Affiliated Group as a Publicly Traded Corporation;[49]
- entities organized under the laws of any possession of the United States and wholly owned, directly or indirectly, by one or more residents of that U.S. possession;

[48] This report will be due by March 15 of the year following the year in which the withholding agent makes the payment.

[49] Publicly traded partnerships will not, as a class, constitute Excepted NFFEs, although some of them may qualify as Active NFFEs.

- Exempt Beneficial Owners;
- Active NFFEs, as defined below; and
- Excluded Entities.

In addition, the proposed regulations provide that a withholding agent will not be required to withhold tax under Section 1472 from any withholdable payment to an NFFE that is a withholding foreign partnership or withholding foreign trust.

An NFFE will be treated as an "**Active NFFE**" if less than 50% of its gross income for the preceding calendar year was passive income or less than 50% of its assets at any time during the preceding calendar year produced, or were held for the production of, passive income. The proposed regulations contain a definition of "passive income" for this purpose. Entities with predominantly passive income and assets will generally constitute Foreign Investment Entities and will therefore be FFIs, rather than NFFEs. As a result, the universe of NFFEs that are not Excepted NFFEs is likely to be quite small.

# VI. Withholding Obligations of Withholding Agents

The FATCA regime operates through the imposition of a 30% U.S. withholding tax on withholdable payments made to persons that do not qualify for an exemption. In broad concept, the rules in the proposed regulations pursuant to which a withholding agent will determine whether a withholdable payment is subject to the FATCA tax are patterned on the corresponding provisions of the non-FATCA withholding rules, with modifications necessary to accommodate the differences between the two regimes.

Beginning on the relevant effective dates, a withholding agent will be required to withhold 30% of any withholdable payment unless the withholding agent has received documentation permitting it to treat the "payee" as exempt from withholding. Any person, U.S. or foreign, that has the control, receipt, custody, disposal or payment of a withholdable payment will be a "**withholding agent**" with respect to that payment. The proposed regulations provide detailed rules for identifying the payee of a withholdable payment and determining the status of the payee for FATCA purposes.

## A. Payee

Because a withholding agent's responsibility to withhold FATCA tax depends on the identity of the payee, the definition of the term "**payee**" is critical to the operation of the FATCA regime. In general, the "payee" is the person to whom a payment is made, but a different rule applies in the case of payments to certain intermediaries and flow-through entities.

The proposed FATCA regulations generally provide that, in the case of a payment to an intermediary or flow-through entity, the "payees" are the persons on whose behalf the intermediary is acting, or the partners, beneficiaries or owners of the flow-through entity, rather than the intermediary or flow-through entity itself. Importantly, however, this rule does not apply to FFIs, other than certain PFFIs receiving withholdable payments of U.S.-source FDAP income. Instead, subject to that exception, an FFI is treated as the payee of a withholdable payment even if it is acting as an intermediary or is a flow-through entity. This approach, which differs from the definition of "payee" in the non-FATCA withholding rules, stems from the fact that the purpose of FATCA is to encourage FFIs to provide information about their U.S.

accounts to the IRS by subjecting withholdable payments to non-participating FFIs to withholding. In order for the system to operate in this manner, a non-participating FFI must be treated as a payee.[50]

A PFFI will not be treated as a payee of any withholdable payment of *U.S.-source FDAP income* if it is an intermediary with respect to the payment (other than a Withholding QI) or flow-through entity (other than a withholding foreign partnership or withholding foreign trust).[51] Rather, the payee(s) of any U.S.-source FDAP income to such a PFFI will be the person(s) on whose behalf the PFFI is acting (in the case of an intermediary) or the partners, beneficiaries or owners of the PFFI (in the case of a flow-through entity).[52]

In general, the location of the branch (including any entity that is disregarded for U.S. federal income tax purposes) that receives a payment is irrelevant for purposes of the imposition of the FATCA tax. In certain circumstances, however, a branch will be treated as a separate payee. In particular, if a withholding agent has agreed to treat the U.S. branch of a PFFI as a U.S. person for purposes of the non-FATCA withholding rules, a payment that the withholding agent makes to the branch will be treated as made to a U.S. person for purposes of FATCA.[53]

## B. Exemptions from Withholding

### 1. Section 1471

A withholding agent will not be required to withhold FATCA tax from any withholdable payment to a payee that is an FFI if the withholding agent has received valid documentation demonstrating that the payee is:

- a PFFI (except as discussed below);
- a deemed-compliant FFI; or
- an Exempt Beneficial Owner.

A withholding agent will generally be required to withhold FATCA tax from any withholdable payment of *U.S.-source FDAP income* to a PFFI that is an intermediary with respect to the payment (other than a Withholding QI) or a flow-through entity (other than a withholding foreign partnership or withholding foreign trust), except to the extent that the PFFI has provided the withholding agent with valid documentation establishing the portion of the payment that is allocable to a class of payees for which no FATCA withholding is required.[54]

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[50] In addition, certain types of Excepted NFFEs – Active NFFEs and Excluded Entities – will be treated as payees even if they are flow-through entities, provided that they are not acting as intermediaries with respect to the withholdable payments.

[51] A Withholding QI will be treated as the payee of any withholdable payment it receives, as will a withholding foreign partnership or withholding foreign trust that is not acting as an intermediary with respect to the payment.

[52] The withholding tax consequences of this treatment are discussed in Parts IV.C.3 and VI.B. As noted in Part IV.C.3, this payee rule is intended to reduce the instances in which over-withholding occurs because a withholding agent applies withholding under the non-FATCA withholding rules to a payment that is also subject to withholding by the PFFI under FATCA.

[53] If a foreign branch of a U.S. financial institution is a QI, a payment to the branch will be treated as made to a foreign payee. In addition, as discussed in Part IV.C.5(ii), a payment to a Limited Branch will be treated as made to a non-participating FFI.

[54] For a description of the documentation that the PFFI must provide, see Part VI.C. A withholding agent will not be required to withhold FATCA tax from payments of U.S.-source FDAP income to a U.S. branch of a PFFI that has elected to be treated as a U.S. person for purposes of the non-FATCA withholding rules. Conversely, a withholding agent is required to withhold FATCA tax from any withholdable payment of U.S.-source FDAP income to a foreign branch of a U.S. financial institution that is a Non-Withholding QI.

If the payee is a non-participating FFI that is an intermediary or flow-through entity, a withholding agent will not be required to withhold FATCA tax to the extent that it has received valid documentation demonstrating that the payment is allocable to a person for which the intermediary is acting, or to a partner, beneficiary or owner of the flow-through entity, that is an Exempt Beneficial Owner (the "**Intermediary for EBO Rule**").

#### 2. Section 1472

Provided that it complies with the information reporting requirements described below, a withholding agent will not be required to withhold FATCA tax from any withholdable payment to a payee that is an NFFE if the withholding agent has received valid documentation demonstrating that the beneficial owner of the payment is:

- an NFFE that does not have any Substantial U.S. Owners;
- an NFFE that has provided identifying information about its Substantial U.S. Owners to the withholding agent; or
- an Excepted NFFE.

As noted above, a withholding agent will be liable for FATCA tax on any withholdable payment that it makes to a payee that is an NFFE (other than an Excepted NFFE), unless it reports certain information relating to each Substantial U.S. Owner of the NFFE, if any, including the name, address and TIN of each such person, to the IRS.

### C. Documentation Supporting an Exemption

To determine whether any withholdable payment is subject to the FATCA tax, a withholding agent will be required to identify the FATCA status of the payee.[55] Like the non-FATCA withholding rules, the proposed FATCA regulations provide for a system of self-certification pursuant to which a payee will identify its FATCA status to withholding agents. A withholding agent must withhold FATCA tax from a withholdable payment unless it can "reliably associate" the payment with "valid documentation" that demonstrates that the payment is exempt from withholding.

A payee will generally certify as to its FATCA status on IRS Form W-9 or W-8, although the proposed regulations permit the use of alternative documentation under certain circumstances. The preamble to the proposed regulations states that the IRS will update Forms W-8 and W-9 to include information relevant to the determination of a payee's FATCA status. The proposed regulations contain detailed rules with respect to the contents and execution of these forms and the standards of knowledge that will apply to withholding agents that collect the forms from payees.[56]

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[55] For example, a withholding agent must determine whether the payee is a U.S. person or a foreign person; whether a foreign payee is an individual or an entity; whether a foreign entity is an FFI or an NFFE; whether an FFI is a PFFI, deemed-compliant FFI, Exempt Beneficial Owner or non-participating FFI; and whether an NFFE is an Excepted NFFE (and, if so, what type of Excepted NFFE).

[56] For example, a PFFI or registered deemed-compliant FFI will be required to supply its FFI-EIN to a withholding agent. The withholding agent will be treated as having reason to know that an entity that claims to be a PFFI or registered deemed-compliant FFI does not actually have that status if the entity's name and FFI-EIN do not appear on the most recently published IRS FFI list within 90 days after the payee submits its form. If an FFI is removed from the IRS FFI list, the withholding agent will be treated as having reason to know that the FFI is not a PFFI or registered deemed-compliant FFI on the earlier of the date on which it discovers that the FFI has been removed from the list and one year from the date of such removal. Withholding agents will thus need to check the IRS FFI list regularly.

In general, a foreign intermediary or flow-through entity that is not a payee for FATCA purposes will be required to provide a withholding statement containing information about the persons who are treated as the payees of any withholdable payment it receives.[57] If the foreign intermediary or flow-through entity is an FFI, this withholding statement may include either:

- pooled information that shows the portion of the payment that is subject to FATCA withholding (because it is attributable to recalcitrant account holders and non-participating FFIs) and the portion of the payment that is exempt from FATCA withholding (because it is attributable to other types of payees) ("**Pooled Information**"); or
- an allocation of the payment to each payee and other information permitting the withholding agent to report the payment to the IRS on Form 1042-S ("**Specific Reporting Information**").[58]

An NFFE will generally be required to provide Specific Reporting Information in any withholding statement it submits, except that an NFFE may provide Pooled Information with respect to payees that are treated as non-participating FFIs.

The proposed regulations provide certain exceptions and special rules for payments with respect to accounts, instruments or contracts maintained or executed by a withholding agent prior to January 1, 2013 or, in the case of a PFFI, prior to the effective date of its FFI Agreement ("**pre-existing obligations**"). In particular:

- a withholding agent will generally not be required to withhold tax under Section 1471 from any payment made prior to **January 1, 2015** with respect to a pre-existing obligation unless the payee is a *prima facie* FFI; and
- for various purposes, a withholding agent will be permitted to rely on documentation collected under the non-FATCA withholding rules in applying the FATCA rules to payments on pre-existing obligations prior to January 1, 2017.

Additional exceptions and special rules apply to payments made outside the United States with respect to any account, instrument or contract maintained or executed at an office or branch of the withholding agent outside the United States. Moreover, a withholding agent may rely for certain purposes on information gathered in the course of its AML compliance, on a review of the payee's financial statements or on letters submitted by the payee's counsel.

As an example, special rules apply to a withholding agent's determination of whether it is required to withhold the FATCA tax from payments to an NFFE. For payments made on pre-existing obligations prior to **January 1, 2017**, the withholding agent may generally rely on the payee's standard industrial classification code, organizational document, financial statement or credit report to determine whether the payee is an Active NFFE. In general, if the NFFE is not an Active NFFE or another type of Excepted NFFE, it will be required to provide a withholding agent with either a written certification that it does not have any Substantial U.S. Owners or the name, address and TIN of each of its Substantial U.S. Owners. In the case of payments on any pre-existing obligation with a value of no more than $1 million, however, a withholding agent that is subject to the laws of a FATF-compliant jurisdiction with respect to the NFFE's

[57] A Withholding QI, or a withholding foreign partnership or withholding foreign trust that is not acting as an intermediary with respect to the relevant payment, will be treated as the payee and will therefore not submit such a withholding statement to a withholding agent.

[58] Because a non-participating FFI is itself the payee for FATCA purposes, it will generally not submit a withholding statement to a withholding agent. In order to rely on the Intermediary for EBO Rule, however, a non-participating FFI that is an intermediary or flow-through entity will be required to submit a withholding statement containing documentation establishing the Exempt Beneficial Owner status of each payee.

account will not be required to collect this information from the NFFE, but instead may rely on information about the NFFE's Substantial U.S. Owners that it collected in the course of its AML due diligence.

The proposed regulations provide presumption rules that assign a deemed FATCA status to any payee for which the withholding agent has not obtained the required documentation. For example, if it does not obtain the required documentation establishing the FATCA status of a foreign entity, a withholding agent will generally be required to presume that the foreign entity is a non-participating FFI. Similarly, to the extent that a withholding agent cannot associate a payment to a foreign intermediary that is not itself the payee of a withholdable payment with valid documentation identifying the status of the underlying payee(s), the payment will be presumed to be made to a non-participating FFI. Certain payees will be presumed to be individuals or U.S. persons, which are not subject to the FATCA tax. However, a withholding agent may not rely on a presumption if it knows, or has reason to know, information indicating that the payee or beneficial owner of a payment is subject to a larger FATCA tax than would be prescribed under the relevant presumption.

## D. Withholding Obligations of Intermediaries and Flow-Through Entities

In general, if an intermediary or flow-through entity that is not treated as the payee of a withholdable payment has submitted the appropriate withholding statements, containing information about the underlying payee(s), to the withholding agent, it will not be required to withhold FATCA tax from any corresponding withholdable payment it makes unless it knows, or has reason to know, that the withholding agent failed to withhold the correct amount of FATCA tax.

A PFFI that is an intermediary (other than a Withholding QI) or flow-through entity (other than a withholding foreign partnership or withholding foreign trust) will be subject to the FATCA tax only in respect of withholdable payments of U.S.-source FDAP income and not in respect of withholdable payments of gross proceeds. A PFFI will therefore not be relieved of its obligation to withhold FATCA tax from withholdable payments of gross proceeds, except as discussed in Part VI.E or as provided in its FFI Agreement.[59]

The proposed regulations state that the obligation of a QI, withholding foreign partnership or withholding foreign trust to withhold FATCA tax from payments that it makes will be determined in accordance with the terms of its agreement with the IRS under the non-FATCA withholding rules, as revised to address the FATCA regime. Because a Non-Withholding QI will be required to make an election under Section 1471(b)(3) to be subject to FATCA tax on withholdable payments of U.S.-source FDAP income it receives, such a QI will presumably be relieved of its withholding responsibility with respect to any corresponding withholdable payments it makes.[60]

## E. Coordination of Withholding Obligations of PFFIs

Pursuant to its FFI Agreement, a PFFI will have certain withholding obligations with respect to withholdable payments and foreign passthru payments that it makes to recalcitrant account holders and non-participating FFIs, as well as with respect to withholdable payments of U.S.-source FDAP income that it makes to Non-Withholding QIs.[61] In addition, without regard to the provisions of its FFI Agreement,

[59] See Part IV.C.3. No earlier than January 1, 2017, a PFFI will also, pursuant to its FFI Agreement, be required to withhold the FATCA tax from foreign passthru payments that it makes to recalcitrant account holders and non-participating FFIs. See Part III.C.

[60] See Part IV.C.3.

[61] For a discussion of these obligations, see Part IV.C.3.

any PFFI that has the control, receipt, custody, disposal or payment of a withholdable payment will be a withholding agent with respect to that payment for purposes of FATCA. The proposed regulations provide that a PFFI that complies with its FFI Agreement will be deemed to have satisfied all of its FATCA withholding obligations.

### F. Liability of Withholding Agents

Any withholding agent that knows, or has reason to know, that it is required to withhold FATCA tax from a payment and fails to do so will be liable for the tax, plus interest and penalties. If a withholding agent does not have valid documentation with respect to a payee, it will generally be liable for any FATCA tax that it fails to withhold unless it appropriately relies on the presumptions set forth in the proposed regulations to treat the payment as exempt from the tax.[62] A withholding agent that fails to withhold will not be liable for the FATCA tax if it can demonstrate that another withholding agent paid the proper amount of tax, but it will nonetheless be liable for any interest or penalties attributable to its failure to withhold.

## VII. Reporting Obligations of Withholding Agents

The proposed regulations require every withholding agent to file IRS Forms 1042 and 1042-S (or such other forms as the IRS may prescribe) with respect to any "FATCA reportable amounts" that it pays in any calendar year. These are the forms on which withholding agents currently report payments of U.S.-source FDAP income to non-U.S. persons under the non-FATCA withholding rules.

### A. Returns and Recipient Copies

In respect of each calendar year, a withholding agent will be required to file:

- one IRS Form 1042, reporting the aggregate FATCA reportable amounts it paid, and the amount of FATCA tax it withheld, during such year;[63] and
- an IRS Form 1042-S for each separate type of payment that it made to each separate "recipient" during such year.

The withholding agent will also be required to furnish a copy of Form 1042-S to each recipient.[64]

A withholding agent will be required to use the same Form 1042 for both FATCA reporting and reporting under the non-FATCA withholding rules. The preamble states that the IRS intends to modify the current Form 1042-S to meet the additional reporting requirements under FATCA and to coordinate reporting in cases in which a payment is subject to reporting under both FATCA and the non-FATCA withholding rules.

In addition to filing Forms 1042 and 1042-S, a U.S. withholding agent that pays a FATCA reportable amount to an owner-documented FFI will be required to report certain information about the FFI and any Specified U.S. Persons that have direct or indirect interests in the FFI.[65] A PFFI's FFI Agreement will

[62] For a discussion of these presumptions, see Part VI.C.

[63] Reporting will be required even if the withholding agent did not withhold any FATCA tax from the relevant payment(s).

[64] Forms 1042 and 1042-S must be filed, and a copy of Form 1042-S must be delivered to the recipient, by March 15 of the year following the year in which the withholding agent paid the FATCA reportable amounts.

[65] See Part IV.B.2(iii).

address the PFFI's reporting requirements with respect to owner-documented FFIs to which it makes payments.

## B. FATCA Reportable Amounts

A "**FATCA reportable amount**" is "an amount reportable on Form 1042-S" for FATCA purposes that is one of the following three types of payments:

- U.S.-source FDAP income paid on or after January 1, 2014, *other than* (i) interest on certain short-term obligations and (ii) payments in the ordinary course of the withholding agent's business for non-financial services, goods or the use of property (neither of which is a "withholdable payment");[66]
- gross proceeds subject to FATCA tax; and
- foreign passthru payments subject to FATCA tax.

## C. Recipients

A withholding agent will be required to report FATCA reportable amounts paid to "recipients." A withholding agent's reporting obligations under FATCA will thus turn on the definition of "recipient."

The concept of "**recipient**" (the person to whom a withholding agent sends a Form 1042-S) is different from the concept of "payee" (the person whose FATCA status determines the amount of FATCA tax that must be withheld from a payment).[67] As a consequence, an intermediary or flow-through entity that is the recipient of a payment for reporting purposes will not necessarily be the payee for withholding purposes, and an intermediary or flow-through entity that is the payee for withholding purposes will not necessarily be the recipient for reporting purposes.

A U.S. person will not be treated as a recipient. A foreign person other than an intermediary or flow-through entity will be treated as the recipient of any payment it receives directly from a withholding agent, as will a Withholding QI, withholding foreign partnership or withholding foreign trust.

The treatment of other intermediaries and flow-through entities is more complicated, and the relevant provisions of the proposed regulations, which differ from the corresponding provisions of the non-FATCA withholding rules, are somewhat difficult to parse.

- *PFFIs.* Whether a PFFI that is an intermediary or flow-through entity will be treated as a recipient will depend on whether the withholding statement that the PFFI provides to the withholding agent contains Pooled Information or Specific Reporting Information about the underlying payees.[68]
  - *Pooled Information.* If a PFFI provides a withholding agent with Pooled Information, the withholding agent will be required to treat the PFFI as the recipient. In that case, the withholding agent will be required to complete a separate Form 1042-S, issued to the PFFI, for each pool.

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[66] Although the definition does not address either effectively connected U.S.-source FDAP income or tax-exempt interest, these types of payments also presumably do not constitute FATCA reportable amounts.

[67] For a discussion of the concept of "payee," see Part VI.A.

[68] For a discussion of the withholding statements that intermediaries or flow-through entities are required to submit to withholding agents, see Part VI.C.

  - *Specific Reporting Information.* To the extent that a PFFI provides Specific Reporting Information with respect to its account holders, the account holders, and not the PFFI, will be treated as the recipients.[69]

- *Non-Participating FFIs.* A non-participating FFI that is an intermediary or flow-through entity will not be treated as a recipient under any circumstances.[70]

- *NFFEs*.

  - *Intermediary.* An NFFE that is an intermediary will under all circumstances be treated as a recipient.

  - *Flow-Through Entity.* An NFFE that is a flow-through entity will not be treated as a recipient unless it is the "payee" of the relevant payment for purposes of the FATCA tax.[71]

In certain situations, a branch of an entity will be treated as a separate recipient, with the result that a withholding agent that pays FATCA reportable amounts to the branch will be required to report those payments separately from payments that it makes to other branches of the relevant entity. The types of branches that will be treated as recipients are (i) Limited Branches of FFIs and (ii) in general, foreign branches of U.S. financial institutions that are QIs.[72]

## D. Reporting Obligations of Intermediaries and Flow-Through Entities

The proposed regulations provide that an intermediary (other than a QI) or flow-through entity (other than a withholding foreign partnership or withholding foreign trust) will not be required to report a withholdable payment if it has provided a valid withholding certificate, including a valid withholding statement, to a withholding agent and it does not know, or have reason to know, that the withholding agent failed to report correctly.[73] The proposed regulations also state, however, that the reporting obligations of a PFFI will be specified in its FFI Agreement. From conversations with the IRS, we understand that Treasury and the IRS are still thinking through the extent of the Form 1042/1042-S reporting obligations of PFFIs that are intermediaries or flow-through entities.

A non-participating FFI will be required to file Forms 1042 and 1042-S, even though the FATCA tax has been withheld from withholdable payments and foreign passthru payments to it. Practically speaking, this means that a non-participating FFI that has not complied with the FATCA-related reporting requriements

[69] The extent to which this rule will apply when a PFFI provides Specific Reporting Information about payees that are not "account holders" is unclear. The rules with respect to registered deemed-compliant FFIs that are intermediaries or flow-through entities appear to be the same as those with respect to PFFIs. The proposed regulations do not address the treatment of certified deemed-compliant FFIs that are intermediaries or flow-through entities.

[70] If a withholding agent makes a payment to a non-participating FFI that is an intermediary or flow-through entity (and is therefore not the recipient), the Form 1042-S must provide the name of the non-participating FFI and describe the recipient of the payment as an "unknown recipient," unless the non-participating FFI has provided Specific Reporting Information in order to take advantage of the Intermediary for EBO Rule.

[71] Thus, an NFFE that is a flow-through entity will be treated as the recipient if it is an Active NFFE or an Excluded Entity. See note 50. In the case of any other type of NFFE that is a flow-through entity, the partners, beneficiaries or owners of the NFFE will be treated as the recipients for reporting purposes.

[72] The non-FATCA withholding rules provide that a U.S. branch of a foreign entity that is treated as a U.S. person for non-FATCA withholding tax purposes will be treated as a recipient. The proposed regulations do not address the treatment of a U.S. branch of a foreign entity for FATCA reporting purposes.

[73] It appears that this exemption will apply without regard to whether the withholding statement contains Pooled Information or Specific Reporting Information.

and later wants to become a PFFI may have to deal with penalties and related interest as a consequence of its prior reporting failures.

### E. Special Reporting Obligations of PFFIs with Respect to Foreign Reportable Amounts

Although a PFFI will not be required to withhold FATCA tax from foreign passthru payments prior to January 1, 2017, it will nevertheless be required to file Forms 1042 and 1042-S with respect to "**foreign reportable amounts**" paid to non-participating FFIs in 2015 and 2016. According to the preamble, the purpose of this transitional reporting requirement is to reduce the incentive for non-participating FFIs to use PFFIs to block the application of the FATCA rules prior to the effective date for the imposition of FATCA tax on foreign passthru payments.

The proposed regulations define a "foreign reportable amount" as a payment of FDAP income that would be a withholdable payment if paid by a U.S. person. While this language seems to encompass all FDAP income, both U.S.-source and foreign-source, it apparently was intended to include only foreign-source FDAP income: the preamble states that the provision requires PFFIs "to report on a payee-specific basis FDAP income from foreign sources." Presumably, the intention was to require reporting of the types of payments that could potentially constitute foreign passthru payments. If that is the case, the reporting obligation is overly broad, because it includes foreign-source FDAP income that would not constitute foreign passthru payments, such as dividends distributed by an NFFE. The proposed regulations reserve on the inclusion of "other financial payments" in the definition of "foreign reportable amounts," and the preamble asks for comments on the types of payments that should be treated as "other financial payments" subject to this reporting obligation.

## VIII. Credits and Refunds

### A. U.S. Federal Tax Return; Credit for FATCA Tax

The proposed regulations state that the entire amount of income, if any, attributable to a payment from which the FATCA tax is required to be withheld "shall be included in gross income in a return required to be made by the beneficial owner of the income." Although this provision appears on its face to require the beneficial owner of any such payment to file a U.S. tax return, the better interpretation would seem to be that the income attributable to a payment subject to the FATCA tax will be includible only in a return *otherwise* required to be filed.[74] A foreign person would presumably be required to file a U.S. federal income tax return in order to claim a refund of the FATCA tax. If a withholding agent fails to withhold the FATCA tax, a beneficial owner that is subject to the FATCA tax may also have a filing obligation.[75] For this purpose, an intermediary or flow-through entity will not be treated as the beneficial owner of any payment to it. Rather, the persons on whose behalf the intermediary is acting, or the partners, beneficiaries or owners of the flow-through entity, will be treated as the beneficial owners.

[74] The provision is included in a section that addresses tax credits, and the preamble to the proposed regulations states that this section "provides rules that are substantially similar to the rules under [Treasury Regulations Section] 1.1462-1 relating to withheld tax as a credit to the beneficial owner of income." Treasury Regulations Section 1.1462-1, which addresses tax credits under the non-FATCA withholding rules, does not impose an independent return filing requirement on non-U.S. persons.

[75] *Cf.* Treasury Regulations Sections 1.6012-1(b), 1.6012-2(g).

Any FATCA tax withheld will be allowable as a credit against the tax liability shown on the beneficial owner's return. For this purpose, amounts that are withheld from payments to an intermediary or flow-through entity will be deemed to have been paid by the beneficial owner except when the intermediary or flow-through entity pays the tax from its own funds and does not withhold with respect to the payment.

### B. Refund of FATCA Tax

Subject to the exceptions discussed below, a beneficial owner will be entitled to claim a refund of any FATCA tax that exceeds the tax liability shown on its return. A beneficial owner may claim a refund only if the FATCA tax was withheld from a payment made, or deemed to be made, to it. If the withholding agent did not withhold the tax, but paid it at a later date to the IRS, the withholding agent, rather than the beneficial owner, will be the person entitled to claim the refund. A withholding agent that claims a refund will be required to prove that the beneficial owner would have been entitled to claim the refund, taking into account the limitations discussed below, if the FATCA tax had been withheld on the payment to the beneficial owner.

Substantial restrictions will apply to the payment of refunds to non-participating FFIs. If a beneficial owner of a payment is a non-participating FFI at the time the payment is made, it will not be entitled to a refund unless it is entitled to a reduced rate of tax pursuant to a tax treaty with the United States. In that case, the refund will be limited to the amount necessary to give effect to the reduction in the tax rate under the treaty, and the non-participating FFI will not be entitled to receive interest from the IRS on the amount of the refund. Thus, a non-participating FFI that is a resident of a country that does not have a comprehensive tax treaty with the United States (*e.g.*, the Cayman Islands or Hong Kong) will not be able to claim a refund of any FATCA tax. A non-participating FFI that, in its capacity as a withholding agent, pays FATCA tax from its own funds with respect to one or more of its account holders will not be entitled to claim a refund of any of the tax, even if it is a resident of a jurisdiction that has a treaty with the United States.

In addition, except to the extent that the NFFE is entitled to a reduced rate of tax under a treaty, the IRS will not refund the FATCA tax to a beneficial owner of a withholdable payment that is an NFFE unless the NFFE attaches to the return on which it claims the refund:

- a certification that it does not have any Substantial U.S. Owners;
- the form that a withholding agent must file with respect to information received from NFFEs reporting the NFFE's name and certain information relating to each Substantial U.S. Owner fo the NFFE, including the name, address and TIN of each Substantial U.S. Owner; or
- other appropriate documentation to establish that FATCA withholding was not required.

## IX. Coordination with Other Withholding Tax Provisions

As noted above, the proposed regulations contain provisions coordinating the withholding requirements of FATCA with existing withholding requirements. Under these provisions, the FATCA tax will be imposed prior to the non-FATCA withholding tax, and a withholding agent will be permitted to credit the FATCA tax it has withheld against its liability for the non-FATCA withholding tax.

In order to enforce the payment of U.S. federal income tax on gain derived by foreign persons from the sale of U.S. real property interests, Section 1445 of the Code generally requires a person who purchases a U.S. real property interest from a foreign seller to withhold 10% of the sales proceeds. Because gain from the sale of a U.S. real property interest is treated as effectively connected income, the gross proceeds derived from the sale of a U.S. real property interest will not constitute a withholdable payment for FATCA purposes. Therefore, an amount subject to withholding under Section 1445 will not be subject to the FATCA tax. A portion of certain corporate distributions is also subject to withholding under Section 1445 because that portion is (or may be) treated as gain from the sale of a U.S. real property interest. The proposed regulations generally provide that withholding under FATCA will not apply to the portion of any corporate distribution that is subject to withholding under Section 1445. To the extent that a corporate distribution is treated as a dividend, however, the FATCA tax will be withheld and allowed as a credit against the non-FATCA withholding tax, as discussed above.

A partnership is required to withhold tax under Section 1446 of the Code in respect of allocations of effectively connected income that it makes to foreign partners. The proposed regulations provide that a withholdable payment or foreign passthru payment that is subject to withholding under Section 1446 will not be subject to withholding under FATCA. They reserve on the determination of the amount of a partnership distribution that will be treated as having been subject to withholding under Section 1446. The proposed regulations also reserve on the coordination of withholding under FATCA with backup withholding, which applies under certain circumstances to certain payments to U.S. persons.

The preamble points out that the proposed regulations do not provide coordination rules for withholding under FATCA and the non-FATCA withholding rules on substitute payments that are part of a chain of securities lending transactions using identical securities. It notes that Notice 2010-46 [76] outlined a proposed withholding and reporting framework under the non-FATCA withholding rules intended to reduce instances of potential excessive or cascading taxation and to account for the role of financial intermediaries in securities lending transactions. Treasury and the IRS requested comments on issues relating to FATCA withholding in the context of these types of transactions.

[76] 2010-1 C.B. 757.

# Appendix A: Certain Applicable Rules of Current Law

The proposed regulations contain various rules that coordinate the FATCA regime with the existing rules for imposing U.S. withholding tax on certain U.S.-source investment income of foreign persons and the corresponding reporting requirements. This Appendix provides a very general overview of the non-FATCA reporting rules.

## A. Taxation of Non-U.S. Persons

Assuming that it is not treated as effectively connected with the conduct of a trade or business in the United States, the gross amount of U.S.-source FDAP income paid to a non-U.S. person is generally subject to non-FATCA withholding tax at the rate of 30%.[77] In general, FDAP income includes all gross income other than gains on the sale of property.[78] Tax treaties between the United States and other countries reduce the rate of, or eliminate, non-FATCA withholding tax on various types of U.S.-source FDAP income derived by residents of the relevant foreign country. In addition, under the Code, certain types of U.S-source FDAP income are exempt from non-FATCA withholding tax. In particular, non-FATCA withholding tax does not apply to "portfolio interest," interest on bank deposits, or interest on certain short-term obligations, defined as obligations payable no more than 183 days after their issue date.[79] The Code and the Treasury regulations provide detailed rules for determining the source (*i.e.*, U.S. or foreign) of various types of FDAP income for U.S. federal income tax purposes.

A different regime applies to income that is "effectively connected" with a trade or business that a non-U.S. person conducts in the United States ("**effectively connected income**"). In general, a non-U.S. person that is engaged in a trade or business in the United States in any taxable year is required to file a U.S. federal income tax return for that year and to pay U.S. federal income tax, at the rates applicable to U.S. persons, in respect of the net effectively connected income that the non-U.S. person derived from the trade or business.[80][81] In addition, absent a reduction or exemption pursuant to a tax treaty, a non-U.S. corporation is subject to U.S. branch profits tax at the rate of 30% on its "dividend equivalent amount" attributable to effectively connected earnings and profits (generally, its after-tax effectively connected income that is not reinvested in the trade or business).[82] Gain derived by a non-U.S. person from the sale or other disposition of a "United States real property interest" (broadly defined and generally including shares in a "United States real property holding corporation") is treated as effectively connected income and is therefore subject to U.S. tax in the manner described above.[83]

Gain derived by a non-U.S. person from the sale or other disposition of property other than a "United States real property interest" is generally not subject to U.S. federal income tax.

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[77] Code Sections 871(a)(1)(A), 881(a)(1), 1441(a), 1442(a).

[78] Treasury Regulations Sections 1.1441-2(b)(1)(i), (b)(2).

[79] Code Sections 871(g), 871(h), 871(i), 881(c), 881(d).

[80] Code Sections 871(b), 873(a), 882(a), 882(c), 6012(a); Treasury Regulations Sections 1.871-8(b)(2), 1.882-1(b)(2), 1.6012-1(b)(1), 1.6012-2(g)(1).

[81] A non-U.S. person that is a resident of a country that has an income tax treaty with the United States, and that is eligible for the benefits of the treaty, will generally be subject to U.S. federal income tax under this regime only if it conducts the trade or business through a permanent establishment in the United States. *See* Treasury Regulations Section 1.871-12.

[82] Code Section 884.

[83] Code Section 897(a)(1).

## B. Withholding and Reporting with Respect to U.S.-Source FDAP Income of Non-U.S. Persons

Under the non-FATCA withholding rules, a withholding agent is required to withhold 30% of any U.S.-source FDAP payment that it makes to a "payee" unless it has received documentation on which it can rely that identifies the payee as a U.S. person or as eligible for a reduced rate of, or exemption from, withholding.[84] For example, a payment of U.S.-source FDAP income may be exempt from the non-FATCA withholding tax because it constitutes effectively connected income or portfolio interest, or it may be subject to withholding tax at a reduced rate pursuant to an applicable tax treaty.[85]

Under the non-FATCA withholding rules, a "payee" of a U.S.-source FDAP payment is generally the person to whom a payment is made.[86] However, if a withholding agent makes a payment to a person that has appropriately certified its status as a foreign intermediary (other than a Withholding QI), the payee is the person on whose behalf the intermediary collects the payment.[87] Similarly, except in the case of a withholding foreign partnership or a withholding foreign trust, the payees of a payment made to a foreign partnership are the partners and the payees of a payment made to a foreign simple trust or foreign grantor trust are the beneficiaries or owners.[88]

The documentation on which a withholding agent relies to identify a payee as a U.S. person or a non-U.S. person is generally a certification provided by the payee itself. In the case of a U.S. person, this certification is generally provided on IRS Form W-9; in the case of a non-U.S. person, it is generally provided on IRS Form W-8. An IRS Form W-8 serves as the basis for applying the portfolio interest exemption; the exemption from backup withholding, which applies under certain circumstances to certain payments to U.S. persons; a reduced rate of, or exemption from, non-FATCA withholding tax under an applicable tax treaty; the exemption from non-FATCA withholding tax applicable to effectively connected income; and the special exemptions from non-FATCA withholding tax applicable to foreign governments and certain other foreign persons with special status. Presumption rules apply for determining the status of a payee that has not submitted the required certification.[89]

There are four types of Form W-8: (i) Form W-8BEN, which is provided by the beneficial owner of U.S.-source income that is not effectively connected income; (ii) Form W-8ECI, which is provided by the beneficial owner of U.S.-source effectively connected income; (iii) Form W-8EXP, which is provided by a beneficial owner of U.S.-source income that is a foreign government or otherwise has certain special status; and (iv) Form W-8IMY, which is provided by a foreign intermediary or flow-through entity. Except as discussed below, a foreign intermediary or flow-through entity must attach to its Form W-8IMY a Form W-9 or the relevant Form W-8 (or other acceptable documentation) with respect to each person for whom it acts (in the case of an intermediary) or each of its partners, beneficiaries or owners (in the case of a flow-through entity).[90] A Form W-8IMY provided by a foreign intermediary is called an "intermediary

[84] Treasury Regulations Section 1.1441-1(b).

[85] Treasury Regulations Section 1.1441-1(b)(4)(i), (viii), (xi).

[86] Treasury Regulations Section 1.1441-1(b)(2)(i).

[87] Treasury Regulations Section 1.1441-1(b)(2)(v)(A).

[88] Treasury Regulations Section 1.1441-5(c)(1), (e)(3).

[89] Treasury Regulations Section 1.1441-1(b)(3).

[90] Treasury Regulations Section 1.1441-1(e)(3)(iv), 1.1441-5(c)(3)(iii), (e)(5)(iii).

withholding certificate," while a Form W-8IMY provided by a foreign partnership or foreign simple or grantor trust is called a "flow-through withholding certificate."[91]

A foreign intermediary that meets certain requirements may become a "qualified intermediary" (or "QI") by entering into a withholding agreement with the IRS (a "**QI Agreement**").[92] A QI is not required to attach the Forms W-8 or W-9 of the persons on whose behalf it collects payments to the Form W-8IMY that it provides to withholding agents. Instead, it either (i) assumes primary withholding responsibility for the non-FATCA withholding tax, in which case it receives U.S.-source FDAP payments free of the non-FATCA withholding tax and withholds the non-FATCA withholding tax itself or (ii) provides the withholding agent with a certification as to the various rates of non-FATCA withholding tax applicable to the payments of U.S.-source FDAP income it receives on behalf of the beneficial owners.[93] Pursuant to its QI Agreement, a QI is required to comply with specified procedures in order to determine the eligibility of the persons on whose behalf it acts for reduced rates of non-FATCA withholding tax.[94]

A foreign financial institution or a foreign clearing organization (as such terms are defined for purposes of the non-FATCA withholding rules) may become a QI, but a U.S. branch or U.S. office of such an institution or organization may not become a QI.[95] Conversely, a foreign branch or office of a U.S. financial institution or U.S. clearing organization may become a QI.[96] If a foreign branch of a U.S. financial institution or clearing organization becomes a QI, it is treated as a foreign person for purposes of the non-FATCA withholding rules with respect to any payment it receives from a withholding agent.[97]

A foreign partnership may become a "withholding foreign partnership" by entering into a withholding agreement with the IRS pursuant to which it assumes U.S. withholding and reporting obligations with respect to its partners' shares of the U.S.-source FDAP income it derives.[98] A foreign simple trust or foreign grantor trust may become a "withholding foreign trust" by entering into a similar withholding agreement with the IRS.[99] A withholding foreign partnership or withholding foreign trust is not required to attach the Forms W-8 or W-9 of its partners, beneficiaries or owners to the W-8IMY that it provides to withholding agents.[100]

Although a payment made to a U.S. branch of a foreign person is generally treated as a payment to a foreign person, a special rule permits a withholding agent to agree to treat a U.S. branch of a foreign regulated entity, such as a bank that is subject to supervision by the Federal Reserve Board or an insurance company that meets certain requirements, as a U.S. person for purposes of withholding on payments to the U.S. branch.[101] In that case, except as discussed below, the withholding agent will not withhold non-FATCA withholding tax from U.S-source FDAP payments to the U.S. branch, and the U.S.

[91] Treasury Regulations Section 1.1441-1(e)(3)(i).

[92] Treasury Regulations Section 1.1441-1(e)(5)(ii).

[93] Treasury Regulations Section 1.1441-1(e)(5)(iv), (v)(C).

[94] Treasury Regulations Section 1.1441-1(e)(5)(iii).

[95] Treasury Regulations Section 1.1441-1(e)(5)(ii)(A).

[96] Treasury Regulations Section 1.1441-1(e)(5)(ii)(B).

[97] Treasury Regulations Section 1.1441-1(c)(2).

[98] Treasury Regulations Section 1.1441-5(c)(2).

[99] Treasury Regulations Section 1.1441-5(e)(5)(v).

[100] Treasury Regulations Section 1.1441-5(c)(2)(i), (e)(5)(v).

[101] Treasury Regulations Section 1.1441-1(b)(2)(iv)(A).

branch will itself be responsible for withholding on these payments.[102] Alternatively, a U.S. branch of such a foreign entity may submit to the withholding agent the appropriate documentation for the persons on whose behalf the U.S. branch receives payments as an intermediary, in which case the withholding agent will treat U.S.-source FDAP payments to the U.S. branch as payments made directly to such persons for purposes of the non-FATCA withholding rules.[103]

A withholding agent that makes payments of U.S.-source FDAP income is required to (i) file an income tax return on IRS Form 1042 reporting the aggregate amount of U.S.-source FDAP payments made, and the aggregate amount of tax withheld, for the relevant calendar year and (ii) file an information return on IRS Form 1042-S for each "recipient" of such payments, as defined for purposes of the non-FATCA withholding rules.[104] The withholding agent must also furnish a copy of Form 1042-S to the recipient with respect to whom it was prepared.[105] A withholding agent must comply with these reporting obligations in respect of any payments it makes to a U.S. branch of a foreign entity, even if it treats the U.S. branch as a U.S. person for purposes of withholding on the payments it makes to the branch.[106]

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[102] Treasury Regulations Section 1.1441-1(b)(2)(iv)(B)(1), (C).

[103] Treasury Regulations Section 1.1441-1(b)(2)(iv)(B)(2).

[104] Treasury Regulations Section 1.1461-1(b)(1), (c)(1)(i).

[105] Treasury Regulations Section 1.1461-1(c)(1)(i).

[106] Treasury Regulations Section 1.1441-1(b)(2)(iv)(A).

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# Appendix B: Defined Terms

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.


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