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Alert Memo

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Treasury and the IRS Release Proposed Regulations under FATCA and a Joint Statement with Other Countries Regarding an Intergovernmental Approach to FATCA Implementation

I. INTRODUCTION.

On February 8, 2012, Treasury and the Internal Revenue Service (the "IRS") released a lengthy and detailed preamble and proposed regulations on the implementation of the Foreign Account Tax Compliance Act ("FATCA"), which was enacted on March 18, 2010 as part of the Hiring Incentives to Restore Employment Act.[1] The proposed regulations incorporate, revise and expand prior preliminary guidance issued in several notices (the "Notices").[2] Accompanying the proposed regulations was an historic joint statement from the United States, France, Germany, Italy, Spain and the United Kingdom regarding their intention to develop an intergovernmental approach to FATCA implementation.[3]

The proposed regulations and joint statement are a welcome and forthcoming response to many of the principal concerns expressed by the financial services industry and other commentators regarding FATCA and the Notices. The proposed regulations provide a clear and detailed picture of many (but not all) aspects of FATCA and a phased implementation of the due diligence, reporting and withholding rules. The key transitional periods and effective dates are summarized below.

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[1] The 389-page notice of proposed rulemaking is available at http://www.irs.gov/pub/newsroom/reg-121647-10.pdf.

[2] Preliminary guidance was issued in Notice 2010-60 (August 27, 2010), Notice 2011-34 (April 8, 2011) and Notice 2011-53 (July 14, 2011). For a discussion of Notice 2010-60, see our memorandum "*First Guidance Regarding Implementation of the FATCA Information Reporting and Withholding Regime*" dated September 8, 2010. For a discussion of Notice 2011-34, see our memorandum "*Second IRS Notice on Implementation of the FATCA Reporting and Withholding Regime*" dated April 13, 2011.

[3] The joint announcement is available at http://www.treasury.gov/press-center/press-releases/Documents/020712%20Treasury%20IRS%20FATCA%20Joint%20Statement.pdf.

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This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Throughout this memorandum, "Cleary Gottlieb" and the "firm" refer to Cleary Gottlieb Steen & Hamilton LLP and its affiliated entities in certain jurisdictions, and the term "offices" includes offices of those affiliated entities.

Treasury and the IRS expect to issue additional guidance, including a draft foreign financial institution ("FFI") agreement and revised IRS Forms W-8 and W-9. Comments on the proposed regulations are due April 30th and a public hearing is scheduled May 15th. Treasury and the IRS have indicated that they intend to issue final regulations later this year.

Our preliminary assessment is that while the proposed regulations take several significant steps towards ensuring that FATCA can be implemented successfully by the IRS and the financial services industry, it will be a challenge for both the IRS and the financial services industry to meet the current timeline for its implementation. Furthermore, the FATCA implementation regime that is envisioned in the proposed regulations remains complex, and will be costly and burdensome to implement for many financial institutions. Aspects that contribute to these difficulties include (i) the limited exclusions (as "deemed-compliant FFIs") for relief from full FATCA compliance that are available for active financial institutions and investment entities that do not pose a significant risk of tax avoidance; (ii) the due diligence and documentation requirements that FFIs and other U.S. withholding agents must perform with respect to the financial accounts of entities, and especially with respect to non-financial foreign entities ("NFFEs") and their "substantial U.S. owners"[4] as well as intermediaries and pass-through entities; (iii) the work that will need to be done to permit FATCA compliance to be accomplished in a manner that is consistent with restrictions on reporting and withholding that are imposed under non-U.S. law; and (iv) the work that will be needed to implement the intergovernmental framework agreement discussed in Part III below.

Because the proposed regulations do not provide broad exclusions and relief that many commentators have requested, a large number of foreign entities will likely be fully subject to the FATCA rules, which will impose substantial compliance costs and burdens on them assuming they become participating FFIs. If the compliance costs and burdens are perceived as too great for these entities, it is possible that disinvestment from the United States could occur. For example, many foreign investment funds – including private equity funds and hedge funds, as well as each of the numerous separate investment entities set up by these funds – will be subject in full to FATCA and will need to become participating FFIs and satisfy the due diligence, documentation and reporting requirements, in order to avoid adverse consequences.

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[4] The term "substantial U.S. owner" is relevant in two contexts. First, an account held by a foreign entity that has one or more substantial U.S. owners is a "U.S. account" that generally is subject to the FATCA due diligence, reporting and withholding rules. Second, NFFEs that are not exempt, as described in footnote 7, are required to provide disclosure regarding any substantial U.S. owners in order to avoid FATCA withholding.

The term "substantial U.S. owner" generally is determined by applying a 10% ownership threshold. However, it includes *every* specified U.S. person (generally, any individual or private entity) that owns any equity interest in an investment entity or an insurance company that issues cash value or annuity contracts.

Part II provides a general overview of the FATCA provisions. Part III then describes the joint statement regarding an intergovernmental approach. Finally, Part IV summarizes the salient aspects of the proposed regulations.

II. OVERVIEW OF FATCA.

The principal goal of FATCA is to prevent tax evasion by U.S. taxpayers. Unfortunately, the rules implementing this objective have a very broad reach. The FATCA provisions introduce a complex and expansive reporting and withholding regime that is intended to force non-U.S. financial intermediaries and U.S.-owned foreign entities to identify and report on U.S. accountholders and investors. This new regime will operate as a parallel system to the existing U.S. withholding tax and information reporting system, including the qualified intermediary ("QI") program.

Under the separate FATCA regime, withholding agents, including FFIs, will be required to withhold a 30% U.S. tax with respect to any "withholdable payment" made to a foreign entity, unless the foreign entity complies with the FATCA reporting requirements or qualifies for an exemption from these provisions. Subject to significant transition rules, this withholding tax will apply to payments made after December 31, 2013. Withholdable payments include (i) U.S.-source dividends, interest or other "fixed or determinable annual or periodical gains, profits, and income" (also known as "FDAP" income); and (ii) any gross proceeds from the sale of assets that can produce U.S.-source dividends or interest. As discussed in greater detail below, these rules generally will not apply to "obligations" that are outstanding on January 1, 2013.

The FATCA rules impose detailed due diligence and reporting requirements for FFIs. An FFI generally will be subject to the 30% U.S. withholding tax on withholdable payments *unless* it becomes a "participating FFI" by entering into an agreement with the IRS pursuant to which it generally will be required to (i) identify and report to the IRS information with respect to certain U.S. persons that directly or indirectly hold depository and custodial accounts at the FFI and equity and debt of the FFI (subject to certain important exceptions described herein), (ii) withhold on "passthru" payments[5] made to "recalcitrant" account holders[6] and account holders that are non-participating FFIs, and (iii) in some cases, close accounts with respect to which reporting is not permitted. FFIs include foreign banks, broker-dealers and entities conducting custodial businesses, as well as any foreign entity

5 "Passthru" payments include not only U.S.-source FDAP income and gross proceeds from the disposition of property producing U.S.-source interest or dividends, but also may include certain foreign-source payments that are "attributable to" such amounts.

6 A "recalcitrant" account holder generally is an account holder that fails to provide information required to determine whether the account is a U.S. account or other information required to be reported by the FFI, or that fails to provide a waiver of any foreign law that would prevent reporting with respect to the account holder.

engaged primarily in the business of investing or trading securities, partnership interests, commodities or any derivative interests therein (*e.g.*, non-U.S. mutual fund-like vehicles such as UCITS and SICAVs, hedge funds, private equity funds, securitization vehicles and virtually any other private or widely held investment entity) and certain foreign insurance companies.

A foreign entity that is not an FFI (which FATCA refers to as an NFFE), and that is not otherwise exempt,[7] will be able to avoid the 30% U.S. withholding tax on withholdable payments only if (i) it provides the name, address and taxpayer identification number of each of its substantial United States owners;[8] (ii) the withholding agent does not know or have any reason to know that the information is incorrect; and (iii) the withholding agent reports that information to the IRS.

III. JOINT ANNOUNCEMENT OF INTERGOVERNMENTAL FRAMEWORK AGREEMENT.

One of the principal concerns that have been raised regarding the adoption of FATCA is that the reporting, withholding and other requirements that it imposes on FFIs may be inconsistent with the laws of a number of other jurisdictions. As a first step toward addressing these concerns, and simplifying the implementation of FATCA more generally, the issuance of the FATCA proposed regulations was accompanied by a joint statement from the United States, France, Germany, Italy, Spain and the United Kingdom regarding their intention to develop an intergovernmental approach to FATCA implementation. This is a significant development in several respects:

- It is intended to address the legal impediments to collecting and reporting information, and to withholding or closing accounts of recalcitrant account holders.

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7 FATCA provides that the following NFFEs generally are exempt from FATCA withholding: (i) corporations the stock of which is regularly traded on an established securities market and their affiliates, (ii) entities that are organized under the laws of a possession of the United States and that are wholly owned by one or more residents of such possession, (iii) foreign governments, (iv) international organizations, and (v) foreign central banks of issue. In addition, the proposed regulations add a number of additional categories of exempt NFFEs, including: (i) governments of U.S. possessions, (ii) certain retirement funds, (iii) "active NFFEs" (*i.e.*, entities whose gross income or assets are predominantly non-passive), (iv) non-financial holding companies, (v) non-financial start-up companies, (vi) nonfinancial entities that are liquidating or emerging from reorganization or bankruptcy, (vii) hedging/financing centers of a non-financial group, and (viii) section 501(c) entities.

8 FATCA generally defines "substantial United States owner" as any "specified United States person" that owns, directly or indirectly, more than 10% of the equity of the NFFE, although in the case of certain investment entities *any* specified United States person is treated as a substantial United States owner, regardless of the size of its ownership interest. A "specified United States person" generally is any U.S. person *other than* regularly traded corporations and their affiliates, banks, governmental entities, RICs, REITs and certain tax-exempt organizations and trusts. The proposed regulations also would exclude from the definition of "specified United States person" securities, commodities and derivatives dealers and brokers.

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  - These countries would agree to pursue necessary implementing legislation requiring FFIs to collect and report information to their government.
  - FFIs in these countries would report FATCA information to their government (instead of to the IRS), which would transfer the information on an automatic basis to the IRS. Thus, there would be no need to withhold on payments to recalcitrant account holders or to close their accounts.
  - All FFIs in these countries would have to become participating FFIs or deemed-compliant FFIs, and thus there would be no FATCA withholding tax on passthru or other payments to FFIs in these countries.

- This framework can be expected to serve as the basis for similar agreements with other countries, thereby enhancing the likelihood of FATCA's successful implementation.
- It is not yet clear whether and to what extent these agreements will provide for deviations from the FATCA proposed regulations in respect of the due diligence that FFIs must perform with respect to accounts, categories of FFIs that are eligible for deemed-compliant status, reporting procedures or other aspects. Unless these points are clarified on a timely basis, the ability of FFIs in these countries to begin to implement FATCA may be delayed.
- The United States is committing to reciprocity with respect to the collecting and reporting on an automatic basis to these countries information on the U.S. accounts of residents of those countries. This commitment can be expected to result in the finalization of the proposed regulations requiring the reporting of interest owed to non-residents of the United States, as well as the imposition of additional due diligence and reporting obligations on U.S. financial institutions.

IV. SUMMARY OF THE PROPOSED REGULATIONS.

1. ***A Phased Implementation Timeline*.** The proposed regulations extend the statutory "grandfather" rule from March 18, 2012 so as to cover all "obligations" outstanding on January 1, 2013.[9] Thus, payments on obligations issued before that date, and any

[9] For this purpose, the term "obligations" means legal agreements that produce or could produce withholdable payments or passthru payments, other than instruments that are treated as equity for U.S. tax purposes or that lack a stated expiration or term (such as a savings deposit or demand deposit). The grandfathering generally covers post-2012 drawdowns under a line of credit or revolving credit facility whose material terms are fixed, but does (continued)

gross proceeds from the disposition of such obligations, generally will not be subject to FATCA. (The proposed regulations do not, however, modify the March 19, 2012 effective date for the repeal of the TEFRA bearer bond rules, and do not contain any guidance in that regard.)

The preamble indicates that Treasury and the IRS intend to release a draft model FFI agreement early this year and registration through an online process is scheduled to begin no later than January 1, 2013.

The ***due diligence requirements*** under the FFI agreement will be phased in over time and based on the account's size and characteristics and whether it is a "preexisting account."[10] In general:

- For pre-existing *entity* accounts, a participating FFI generally must complete the required diligence within one year of the effective date of its FFI agreement for any account holder that is a "prima facie FFI,"[11] and within two years of the effective date of its FFI agreement for other accounts (accounts with balances of $250,000 or less may be exempt, however).

- For preexisting *individual* accounts, a participating FFI generally must complete the required diligence within one year of the effective date of its FFI agreement for "high-value accounts" (*i.e.*, accounts having a balance or value that exceeds $1 million), and within two years of the effective date of the FFI agreement for other accounts.

The ***reporting requirements*** also will be phased in over a number of years:

- Reporting for calendar year 2013 and 2014: The information that participating FFIs must report with respect to 2013 and 2014 is limited to

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not cover post-2012 transactions pursuant to a master agreement (*e.g.*, a derivatives transaction confirmation under an ISDA master agreement), nor does it cover an obligation once it has been materially modified for purposes of section 1001.

[10] A "pre-existing" account is an account maintained as of January 1, 2013.

[11] An entity is treated as a prima facie FFI if (i) the withholding agent's electronically searchable information indicates that the payee is a QI or non-qualified intermediary for normal withholding tax purposes; or (ii) for an account maintained in the United States, the payee is presumed to be a foreign entity, or is documented as a foreign entity for purposes of the regular withholding tax or information reporting rules, and the withholding agent has recorded as part of its electronically searchable information a standardized industry code that indicates that the payee is a financial institution. The proposed regulations provide a short list of North American Industry Classification System ("NAICS") and Standard Industrial Classification ("SIC") codes that indicate that the payee is a financial institution.

basic account holder identifying information and the account balance or value as of the end of the year.[12] No payments made with respect to the account will be required to be reported.

- Reporting for calendar year 2015: In addition to the information required to be reported with respect to 2013 and 2014, the aggregate gross amounts of interest, dividends and other income paid or credited to the account must be reported. No gross proceeds reporting will be required for 2015.
- Reporting for calendar year 2016 and later years: Full reporting will be required.

The ***withholding requirements*** will be phased in over a number of years as well:

- Beginning on January 1, 2014, U.S.-source FDAP income will be subject to withholding if paid to new accounts or pre-existing accounts held by prima facie FFIs (until appropriate documentation is provided).[13]
- On January 1, 2015, withholding requirements generally will expand to include other pre-existing accounts, and will apply to gross proceeds from the disposition of property producing U.S.-source interest or dividends, in addition to U.S.-source FDAP income (until appropriate documentation is provided).

2. ***Withholding on Passthru Payments*.** A very controversial aspect of Notice 2011-34 was the requirement that an FFI withhold on the "passthru payment percentage" of each payment to a nonparticipating FFI or recalcitrant account holder (other than on U.S.-source FDAP income and gross proceeds, which are generally subject to FATCA withholding as withholdable payments). *The proposed regulations defer the withholding on such foreign passthru payments at least until 2017, but require participating FFIs to report annually the aggregate amount of certain payments to nonparticipating FFIs, beginning for calendar year 2015.*[14]

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[12] A participating FFI's reporting for the 2013 calendar year will not be due until September 30, 2014 and will be based on accounts held as of June 30, 2014.

[13] The corresponding due diligence rule provides that an FFI that has an account holder that is a prima facie FFI has one year from the effective date of its FFI agreement to confirm the account holder's status, but the withholding rule described in the text appears unequivocally to require withholding beginning on January 1, 2014 if documentation of the prima facie FFI's status has not been obtained.

[14] Because the proposed regulations reserve on the treatment of foreign-source passthru payments, swap payments made by FFIs to nonparticipating FFIs generally should not be subject to FATCA withholding until at least 2017, except for dividend equivalent payments that are treated as U.S.-source dividends under section 871(m).

3. ***The Scope of the FATCA Rules Has Been Narrowed*** in several important respects, including:

   - A "financial account" no longer includes any debt or equity interest in an FFI that is a bank or that holds financial assets for the account of others, regardless of whether the interest is regularly traded on an established securities market, so long as the value of the debt or equity interest is not determined, directly or indirectly, primarily by reference to assets that give rise to withholdable payments (such as certain structured notes). Thus, foreign banks will not need to treat holders of their privately placed conventional debt as holding FATCA accounts.

   - Payments on short-term debt obligations (those having an original term to maturity of 183 days or less), including U.S. Treasury bills, are excluded from "withholdable payments." Thus, payments on such obligations generally will not be subject to FATCA's reporting and withholding requirements.

   - Payments made in the ordinary course of a withholding agent's business for nonfinancial services, goods and the use of property (such as wages, leases and interest on related accounts payable) are excluded from "withholdable payments" and will not be subject to FATCA.

   - Effectively connected income ("ECI") attributable, in the case of an income tax treaty, to a U.S. permanent establishment is not a "withholdable payment." Thus, for example, payments received by a U.S. branch of a foreign bank (other than in its capacity as an intermediary for another office or another person) will not be subject to FATCA.[15]

4. ***Only Limited Categories of FFIs Have Been Excluded from the Scope of FATCA*.** The financial industry had hoped that many types of active financial institutions and investment entities would be excluded altogether or relieved from many of the compliance burdens of FATCA because they present a low risk of tax evasion. While the IRS has helpfully clarified and expanded several exceptions (including for retirement plans and non-profit institutions, as well as for NFFEs that are engaged in an active business) and has suggested that the intergovernmental framework might expand the number of deemed-compliant FFIs, the exceptions that are provided for active financial institutions and investment entities are not as broad as commentators had requested. Accordingly, a large number of entities will likely be fully subject to

[15] As indicated in footnote 28 below, however, it is unclear whether a withholding agent can presume that a payment to a U.S. branch is ECI or must receive a Form W-8 to determine the branch's status.

the FATCA rules, which will impose substantial compliance costs and burdens on them, assuming they become participating FFIs (including the due diligence and documentation of entity accounts as described in Section IV.5, below) and could possibly lead to their disinvestment from the United States if the compliance costs and burdens are perceived as too great.

- *Active Financial Institutions*. The proposed regulations have helpfully added several categories of deemed-compliant FFIs. While Treasury and the IRS have presumably investigated the banking industry in various countries in formulating these exceptions, it is unclear whether they will be adequate given their limited scope and restrictive conditions. The principal exceptions that have been provided are:
    - An FFI member of a participating FFI group can register with the IRS as a "nonreporting member" if it identifies all of its pre-existing nonparticipating FFI and U.S. accounts and moves them to a participating FFI affiliate, or closes the accounts, within 90 days, and sets up policies and procedures to transfer any such future accounts to a participating FFI affiliate.
    - A "local FFI" can register with the IRS as a deemed-compliant FFI if it meets certain restrictive conditions, including that it (and each member of its expanded affiliated group[16]) cannot have an office or solicit customers outside its country of organization, at least 98% of its accounts must be held by residents of its home country (or of the EU if its country is a member state of the EU) and it must implement policies to ensure that it does not open or maintain accounts for any specified U.S. person who is not a local resident, any nonparticipating FFI or any entity controlled or beneficially owned by a specified U.S. person.
    - A "nonregistering local bank" must be registered as a bank and engage primarily in the business of making loans and taking deposits from unrelated retail customers, cannot have an office or solicit customers outside its country of organization, cannot have more than $175 million in assets (and the group of which it is a member cannot have more than $500 million in assets), and must be subject to either

[16] An "expanded affiliated group" generally is an affiliated group in which each subsidiary is linked to a common parent through 50%-or-greater equity holdings, measured by both vote and value. In the case of a partnership or other non-corporate entity, the 50% ownership test is measured solely by value.

local information reporting or withholding with respect to resident accounts (or only maintain accounts of $50,000 or less).

- A bank or custodian FFI (or FFI group) with only "low-value accounts" must have no financial account with a balance or value in excess of $50,000 and no more than $50 million in assets.

- *Investment Entities*. The principal exceptions that have been provided are:

  - A "qualified collective investment vehicle" ("QCIV") can register with the IRS if, inter alia, it is regulated as an investment fund[17] and each holder of record of debt (in excess of $50,000) and equity interests or any other holder of a financial account with the QCIV is a participating FFI, a registered deemed-compliant FFI, a U.S. person that is not a specified U.S. person or an exempt beneficial owner. A QCIV would be attractive for investment vehicles that are "captives" of such investors and/or can have their non-qualifying investors invest through accounts with participating FFIs.

  - A "restricted fund" can register with the IRS if, inter alia, (i) it is regulated as an investment fund; (ii) interests in the fund may only be sold through distributors that are participating FFIs or that meet other qualifications, or may be redeemed directly by the fund; (iii) the distribution agreements prohibit sales to U.S. persons, nonparticipating FFIs, and passive NFFEs with substantial U.S. owners; and (iv) the fund follows certain procedures and makes certifications regarding compliance with the sale and ownership restrictions. It will be interesting to see whether market practice develops towards greater use of restricted funds.

  - The statute exempts from FATCA debt and equity interests that are regularly traded on an established securities market. Under the proposed regulations, an established securities market includes, inter alia, an officially recognized foreign securities exchange (or separate tier or market level thereof) with a 3-year annual trading volume of over $1 billion (as reported by the International Federation of Stock Exchanges). A class of interests is regularly traded if there is trading (other than in de minimis quantities) on at least 60 days during the

[17] The proposed regulations do not elaborate on the nature or the extent of the required regulation in order for an investment fund to qualify as a QCIV.

prior calendar year and the aggregate number of interests traded in that year is at least 10% of the volume outstanding.

- An FFI that is an investment entity can become an "owner-documented FFI" by agreement with a withholding agent if they agree that, inter alia, the owners of the entity will provide necessary documentation regarding their identity which the withholding agent will report to the IRS, and the entity does not maintain any financial account for a nonparticipating FFI or issue debt that constitutes a financial account to any person in excess of $50,000. While somewhat unwieldy, this exemption is intended to permit family investment vehicles and similar entities to be treated as conduits for purposes of FATCA compliance.

Investment funds – including private equity funds and hedge funds, as well as individual investment entities set up by these funds – that do not meet the foregoing limited exceptions will be subject in full to FATCA, and will need to become participating FFIs and satisfy the due diligence and documentation requirements described in Section IV.5, below, and the reporting requirements described in Section IV.6, below, in order to avoid adverse consequences.[18]

- *Securitization Vehicles and Other Special Purpose Vehicles ("SPVs")*. Under the proposed regulations, a securitization vehicle or other SPV that holds assets giving rise to withholdable payments (or for that matter, any withholding agent) should be able to minimize its FATCA compliance burdens to the extent that its interests are held by a participating FFI or a U.S. financial institution, including a clearing organization, since in that case the FATCA compliance responsibilities would be shifted to the financial intermediaries in the ownership chain (although the SPV would have to enter into an FFI agreement and perform FATCA due diligence, reporting and

[18] Notice 2011-34 indicates that Treasury and the IRS are considering providing a centralized compliance option for certain groups of investment funds that would permit a common asset manager or agent to execute a single FFI agreement and perform the required functions on behalf of each member of the group of funds. Although such an option would substantially simplify the ability of some investment funds to comply with FATCA, the proposed regulations do not address this possibility, and it is unclear whether the IRS intends to implement it through future guidance.

The proposed regulations helpfully incorporate by reference the provisions in the section 1441 regulations relating to coordinated account information systems, which permit withholding agents to rely on documentation provided to affiliates under specified circumstances. These rules also permit a common investment advisor or underwriter for a group of mutual funds to collect a single set of documentation with respect to the shares issued by the funds. It would be helpful if these rules were expanded to common investment advisors of other investment fund families, such as private equity fund or hedge fund groups.

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withholding with respect to any interests not held through such a financial institution).[19]

5. ***Account Due Diligence Requirements of FFIs and Other U.S. Withholding Agents.*** The due diligence procedures that FFIs and other U.S. withholding agents are required to undertake for pre-existing and new accounts have been relaxed, and the dollar thresholds have been raised.[20] For FFIs, these rules appear to be workable for individual accounts, but will be fairly burdensome for entity accounts, especially (i) new accounts and (ii) pre-existing accounts of passive investment entities with account balances in excess of $1 million. Highlights of the most salient points are:

   - *FFI Pre-Existing Offshore Individual Accounts*. An electronic search for U.S. indicia[21] generally suffices for all accounts with balances up to $1 million (increased from $500,000 under the Notices); accounts of $50,000 or less ($250,000 or less in the case of cash value insurance or annuity contracts) need not be searched at all.[22] Only high-value accounts (with balances in excess of $1 million) need an enhanced inquiry of relationship managers and, to the extent the information regarding U.S. indicia is not available from the electronic search, review of the current master files and other specified documents that were obtained within the last 5 years. These requirements apply to all pre-existing accounts, and replace the Notices' proposed treatment of private banking accounts. The limitations on the nature of the documentation required to be reviewed and the 5-year limitation also are a significant relaxation compared to the comparable provisions described in the Notices. The review and documentation of high-value

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19 Also, the preamble requests comments "on whether it is appropriate to treat as grandfathered obligations certain equity interests in securitization vehicles that invest solely in debt and similar instruments if such vehicles will liquidate within a specified time frame . . . ." In addition to adopting any such grandfathering rule, it would be helpful if the regulations further provided that an entity will be deemed compliant if all of the interests it issues (or any other accounts that it holds) are grandfathered.

20 As discussed in Section IV.1, above, these procedures will be phased in over time.

21 The proposed regulations provide that an account holder is treated as having U.S. indicia if the information that the FFI is required to review includes (i) identification of the account holder as a U.S. resident or citizen, (ii) a U.S. place of birth, (iii) a U.S. resident address or U.S. mailing address (including a U.S. post office box), (iv) a U.S. telephone number, (v) standing instructions to transfer funds to an account maintained in the United States, (vi) a power of attorney or signatory authority granted to a person with a U.S. address or (vii) an "in-care-of" address or "hold mail" address that is the sole address the FFI has identified for the account holder (which in some cases is limited to an "in-care-of" address in the United States).

22 In applying these thresholds (and the entity thresholds described below), all accounts held by the FFI or its affiliates for the account holder must be aggregated if, but only if, the FFI's computerized systems link the accounts by reference to data such as a client number or taxpayer identification number, and the systems permit the balances of such accounts to be aggregated.

accounts must be completed within one year of the effective date of the FFI agreement, and of other accounts within two years.

- *FFI New Offshore Individual Accounts*. An FFI may generally rely on documentary evidence (including most types of governmental identification) that establishes an individual's status as a U.S. or non-U.S. person, but must also review all information collected with respect to the opening or maintenance of each account for U.S. indicia, including a U.S. place of birth.

- *FFI Pre-Existing Entity Accounts*. No review is required of offshore entity accounts with balances of $250,000 or less until the account balance exceeds $1 million. The preamble suggests that for other accounts, "FFIs can generally rely on AML/KYC records and other existing account information to determine whether the entity is an FFI, is a U.S. person, is excepted from the requirement to document its substantial U.S. owners (for example, because it is engaged in a nonfinancial trade or business), or is a passive investment entity (referred to in the regulations as a 'passive NFFE')." The proposed regulations also helpfully provide that FFIs may generally rely on information collected for AML/KYC due diligence purposes to identify substantial U.S. owners of passive NFFEs with account balances that do not exceed $1 million.

    - However, the proposed regulations impose conditions for many of the required determinations that are unlikely to be satisfied by existing account information, so it appears quite likely that FFIs will need to obtain certifications or other information from numerous pre-existing entity accounts.[23]

    - In any event, FFIs will need to obtain information regarding all substantial U.S. owners of passive NFFEs with account balances that exceed $1 million, or a certification that the entity does not have substantial U.S. owners.

- *FFI New Offshore Entity Accounts*. The proposed regulations impose extensive and detailed requirements for the numerous categories of entity accounts, many of which may be difficult to satisfy from readily available information. Therefore, it appears quite likely that FFIs will need to obtain certifications or other information from the holders of many new entity accounts.

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[23] In some cases, the application of the presumption rules or specific transition rules may alleviate this burden somewhat, although clarification is needed regarding the interplay of these rules.

- *Onshore Accounts of U.S. Withholding Agents (Including U.S. Branches of Foreign Banks)*. In general, U.S. withholding agents, including U.S. branches of foreign banks that elect to be treated as U.S. persons, will need to obtain a new IRS Form W-8, W-9 or other withholding certificate from virtually all entity accounts satisfying the conditions of the new rules. However, in many cases transitional exceptions will apply for payments made prior to January 1, 2017 with respect to pre-existing accounts, so long as the U.S. withholding agent has available to it (or is provided by the account holder) the necessary information regarding the account holder's status. In any event, U.S. withholding agents will need to obtain information regarding all substantial U.S. owners of passive NFFEs (in the case of existing accounts, only those with account balances that exceed $1 million), or a certification that the entity does not have substantial U.S. owners. For new accounts and those not covered by the transitional relief, the documentation needs to be in place by December 31, 2013.

- *Complicated Rules Regarding NFFEs, Intermediaries and Passthrough Entities*. The proposed regulations require U.S. withholding agents to determine who is the "payee" on the basis of whether an account holder that is an FFI or NFFE is acting as an intermediary and whether it is a passthrough entity under U.S. tax principles, which will usually require a certification from the account holder. The proposed regulations require FFIs to apply the "principles" of these rules, but also contain certain presumptions that may obviate the need for FFIs to obtain such U.S. tax-specific information or a certification from their entity account holders, under penalties of perjury, in at least some circumstances. Further clarification in this regard will be crucial to the workability of the new rules. Other complexities arise from the lack of clarity in the classification of an entity as a passive NFFE or as an investment entity FFI of a kind that would be eligible for treatment as an owner-documented FFI (and the unwieldy requirements for such treatment).[24]

- *Further Diligence Regarding Participating FFIs*. The proposed regulations provide that if an FFI is removed from the IRS's list of participating FFIs and registered deemed-compliant FFIs, the withholding agent will be required to treat the FFI as no longer qualifying on the earlier of the date on which the withholding agent discovers that the FFI has been removed from the list or

[24] Also, apparently an entity that is an investment subsidiary of a publicly traded, active business NFFE will not qualify for the exemption for NFFE affiliates because that exemption seems to require that the entity be an NFFE, whereas it would be an FFI. Unless this rule is revised, it will create due diligence burdens for FFIs and impossible compliance hurdles for such investment subsidiaries since they will not be able to identify each of their indirect U.S. owners, if any.

the date that is one year from the date the FFI's name was actually removed from the list. Thus, as a practical matter, withholding agents (including FFIs) will likely be required to adopt procedures to allow them to confirm the status of all of their account holders that are participating FFIs or registered deemed-compliant FFIs at least annually.

6. ***Reporting Requirements.*** As described in Section IV.1, above, the FATCA reporting requirements will gradually be phased in beginning in late 2014. The proposed regulations contemplate that the reporting will be coordinated with reporting under the existing withholding tax rules, and Forms 1042 and 1042-S and the procedures for filing those forms will be revised accordingly.

   The proposed regulations permit an FFI that is a QI to simplify the withholding obligations that otherwise would be imposed on it by electing to be subject to withholding on payments it receives, to the extent those payments are allocable to recalcitrant account holders or nonparticipating FFIs. This election requires that the electing FFI provide the relevant withholding agent with the information required to apply the withholding rules properly, but does not require the consent of the relevant withholding agent. Thus, the election may be expected to increase the burdens on withholding agents, although its impact may be tempered by the fact that it is limited to payees that are QIs.

7. ***Verification Requirements.*** The proposed regulations adopt streamlined verification procedures that generally will not involve external audits of FFIs. Rather, FFIs will be required to adopt written policies and procedures governing their due diligence, withholding and reporting procedures and will be required to conduct periodic internal reviews of their FATCA compliance. A responsible officer of the FFI will be required to provide periodic certifications to the IRS regarding the FFI's compliance and may be required to disclose material failures.[25] Additionally, within one year of the effective date of the FFI's FFI agreement, the responsible officer must certify (i) that the FFI has completed the review of high-value accounts described above and (ii) that to the best of the responsible officer's knowledge, after conducting a reasonable inquiry, the FFI did not have any formal or informal practices or procedures in place from August 6, 2011 through the date of such certification to assist account holders in avoiding FATCA.[26] Within two years of the

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[25] The proposed regulations do not define the term "responsible officer." The use of "responsible officer" certifications to verify compliance was first described in Notice 2011-34, which indicated that the term referred to the FFI's chief compliance officer or another equivalent-level officer. It is unclear whether the IRS contemplates that an appropriate lower-level officer might also provide the certification.

[26] The preamble requests comments regarding alternative procedures for FFIs that are unable to provide this certification.

effective date of the FFI's FFI agreement, the responsible officer generally must certify that it has completed the account identification procedures and documentation requirements for all preexisting accounts.

The proposed regulations do not require periodic external audits, and specifically provide that random external audits will not be required.[27]

8. ***"All or None" Rule for FFI Groups and Limited Relief for Foreign Legal Conflicts.*** The proposed regulations generally provide that an FFI can be a participating FFI only if every member of its expanded affiliated group also is a participating FFI or is a deemed-compliant entity. The proposed regulations provide limited transitional relief from this requirement in the case of FFIs (or their branches) that cannot, under local law, comply with FATCA's reporting, withholding or account closure requirements. Under this special "limited FFI" rule, the affected FFI (or branch) must (i) agree to perform account holder due diligence, retain account holder documentation and report with respect to U.S. accounts to the extent it is permitted to do so; (ii) agree not to open U.S. accounts or accounts for non-participating FFIs; and (iii) agree that it will be treated as a non-participating FFI with respect to any payments it receives from other withholding agents.

   The special rules for limited FFIs and limited branches apply only through December 31, 2015. Thus, after that date, all of an FFI's branches and affiliates will be required to be participating FFIs or deemed-compliant entities in order for the FFI to qualify as a participating FFI. Moreover, the limited FFI and limited branch rules apply only if one or more affiliated FFIs (in the case of the limited FFI rule) or one or more branches (in the case of the limited branch rule) are participating FFIs. Thus, the rules provide no relief to an FFI if all of its branches are subject to foreign legal restrictions on compliance and it has no affiliates that are not subject to such restrictions.

9. ***U.S. Banking Branch of a Participating FFI.*** The proposed regulations' treatment of U.S. banking branches of participating FFIs generally conforms to their treatment for section 1441 withholding tax purposes. Thus, a withholdable payment to a U.S. banking branch of a participating FFI will be treated as a payment to a U.S. person if the U.S. branch and the withholding agent have agreed to treat the U.S. branch as a U.S. person for purposes of the section 1441 withholding tax rules.[28] Accordingly,

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[27] The proposed regulations indicate that an external audit may be required if the IRS identifies concerns about the FFI's compliance based on the reporting and certifications provided by the FFI, although the preamble suggests that such audits will be required only in the case of "repetitive or systematic failures."

[28] The FATCA rules should clarify the results where the U.S. branch does not enter into such an agreement with a withholding agent. The section 1441 rules contain a presumption that such a payment is ECI in the absence of certain factors and thus is exempt from withholding. That ECI presumption is not explicitly reflected in the (continued)

U.S branches can generally interact with their U.S. counterparts on the same basis as their U.S. banking competitors. The proposed regulations also contain guidance regarding the applicable reporting and withholding rules for such U.S. branches that integrates the FATCA rules with the U.S. reporting and withholding rules to which they are subject.

10. ***Overwithholding and Refunds.*** The withholding tax imposed under FATCA is not intended as an additional substantive tax. Thus, the proposed regulations provide that the beneficial owner of a payment may credit any FATCA withholding against any substantive tax liability due under the Internal Revenue Code, and is entitled to a refund of any excess, subject to certain conditions. Beneficial owners that are entities may be required to establish whether they are U.S.-owned foreign entities and to provide information regarding any substantial U.S. owners. Beneficial owners that are FFIs are only entitled to refunds to the extent required by a tax treaty.

    Although the proposed regulations provide for a right to refunds, the details of the refund process have not yet been fully developed, so it remains to be seen whether the process (including the documentation that beneficial owners will be required to provide) will be efficient and workable.

11. ***U.S. Place of Birth.*** The due diligence rules applicable to accounts held by individuals identify a number of "U.S. indicia" that may indicate that an account holder is a U.S. person, which generally require that an FFI tentatively classify the account holder as a U.S. person.[29] The proposed regulations then provide a series of special rules that specify the means by which an account holder may refute the presumption of U.S. status, some of which may be difficult to apply in practice. In particular, if the account holder information held by the FFI indicates that the account holder has a U.S. place of birth, the FFI generally will be permitted to treat the account holder as a non-U.S. person only if the account holder provides (i) a Form W-8BEN, certifying non-U.S. status; (ii) a non-U.S. passport or other government-issued identification evidencing citizenship in a country other than the United States; *and* (iii) a copy of the individual's Certificate of Loss of Nationality of the United States, or a reasonable explanation of the account holder's renunciation of U.S. citizenship or the reason the account holder did not obtain U.S. citizenship at birth. Many life-long non-U.S. residents whose only connection to the United States

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proposed regulations. It would be desirable for there to be symmetrical treatment of U.S. branches for section 1441 and FATCA purposes.

[29] Similar rules also apply to determine when a withholding agent has reason to know that documentation establishing non-U.S. status may be incorrect.

is as a place of birth may find it difficult, if not impossible, to satisfy these requirements.

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Please feel free to contact any of your regular contacts at the firm or any of our U.S. partners and counsel listed under Tax in the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

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