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U.S. Treasury Department and Internal Revenue Service Issue Supplementary FATCA Guidance

JAMES BARRY, DONALD MORRIS, JONATHAN SAMBUR, AND MEGAN HALL

The authors review the key provisions of a recent IRS notice regarding reporting and withholding requirements on non-U.S. financial intermediaries and investment entities.

The Internal Revenue Service (the "IRS") has released Notice 2011-34 (the "Notice") regarding reporting and withholding requirements pursuant to FATCA (Sections 1471 through 1474 of the Internal Revenue Code (the "Code")).[1] The Notice supplements preliminary guidance regarding the implementation of FATCA published in Notice 2010-60.[2]

Generally, FATCA imposes significant due diligence, information reporting and control burdens on non-U.S. financial intermediaries and investment entities. These foreign financial institutions ("FFIs") must disclose their U.S.-owned accounts to the IRS or, in some cases, impose a 30 percent withholding tax on payments to account holders. Subject to certain exclusions regarding "grandfathered" obligations, FATCA is effective with respect to payments made on or after January 1, 2013.

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The Notice:

- Provides additional guidance in response to the extensive comments submitted to the Treasury Department ("Treasury") and the IRS following the publication of Notice 2010-60, but also requests comments with respect to certain other issues;
- Substantially revises prior guidance provided in Notice 2010-60 with respect to due diligence associated with the classification of preexisting accounts;
- Provides necessary guidance with respect to ascertaining the portion of a payment that is considered a passthru payment;
- Provides procedural guidance regarding the reporting of U.S. accounts;
- Provides additional guidance regarding the classification of certain non-U.S. investment funds and "local" FFIs engaged in the banking business as deemed compliant FFIs; and
- Provides guidance regarding the treatment of certain expanded affiliated groups.

Treasury and the IRS have indicated that future guidance will contain a model FFI agreement and that other future guidance may address the treatment of certain insurers, widely traded funds, and retirement plans.

REVISED DUE DILIGENCE OBLIGATIONS PERTAINING TO PREEXISTING INDIVIDUAL ACCOUNTS

Section I of the Notice replaces the guidance provided in Notice 2010-60, in its entirety, with respect to the due diligence process applicable to an FFI's preexisting individual accounts. The Notice provides a six-step process that FFIs must follow to identify U.S. accounts among their preexisting individual accounts. The Notice also contains procedures under which an FFI is permitted to self-certify that it has complied with the relevant procedures.

Regarding preexisting individual accounts, the Notice requires FFIs to determine whether the accounts are: U.S. accounts, accounts of recalcitrant account holders ("recalcitrant accounts"), or accounts that are other than

U.S. accounts ("non-U.S. accounts"). To make this determination the FFI may rely on documents it collects and those already in the account holder's files (and in the case of a private banking account, discussed below, information known to the relationship manager that services such account, whether or not such information is contained in the account holder's file) unless the FFI knows, or has reason to know, that the documentation is unreliable.

In addition, the FFI is required to treat all accounts maintained by the FFI or its affiliates that are associated with one another due to partial or complete common ownership as one account.[3] For purposes of conducting this review, accounts are aggregated only to the extent that an FFI or an affiliate of an affiliated group of FFIs shares such information between its affiliates or among its branches.

The Notice outlines a six step inquiry for FFIs to use in order to isolate its pre-existing accounts into particular groups.

Due Diligence Procedures

Step 1: Identify Documented U.S. Persons and Exclude Low Value Depository Accounts

All account holders already documented as U.S. persons for other purposes (e.g., for purposes of Chapter 3 of the Code, Section 6041 et seq. information reporting or backup withholding) will be treated as specified U.S. persons and their accounts will be treated as U.S. accounts. Unless the FFI otherwise elects, depository accounts of all natural persons (including documented U.S. persons) that have a balance of less than $50,000 will be treated as non-U.S. accounts. Accordingly, Step 1 should result in the disclosure of documented U.S. persons that have securities or other custody accounts with an FFI, own any non-publicly traded debt or equity interest in an FFI, or have a depository account with an FFI, the balance of which exceeds $50,000.

Step 2: Exclude Remaining Low Value Accounts

All accounts that have a balance that does not exceed $50,000, other than those accounts identified as U.S. accounts in Step 1, will be considered non-U.S. accounts. An FFI may elect not to apply this step. Accordingly, FFIs that

do apply this step should be able to exclude a significant number of low-value accounts and focus their due diligence efforts on accounts identified in Steps 3 through 5.

Step 3: Extensive Due Diligence Imposed on Private Banking Accounts

An FFI is required to perform certain enhanced due diligence with respect to "private banking" accounts that are not identified as U.S. accounts under Step 1. The Notice defines a private banking account broadly to include certain banking relationships that are maintained by the FFI's "private banking department," which can include:

- the FFI's specialized wealth management or similar group,
- the FFI's banking group that focuses on serving individual, generally high net worth, clients,
- the FFI that is considered a private banking department pursuant to the applicable anti-money laundering or know-your-customer rules to which the FFI is subject, or
- the FFI's employees that (a) provide personalized services to clients and their families (including the provision of personalized investment advice not generally provided to account holders) or (b) gather certain information about a client's personal financial history in addition to the information ordinarily gathered with respect to an ordinary retail client.

Step 3 is likely to impose a significant burden on an FFI, particularly on the private banking relationship managers ("RMs") employed by the FFI. The Notice requires the RM to conduct enhanced due diligence with respect to that RM's clients based on the information maintained within the client's account file as well as other information known to the RM that is not contained in the account file. In other words, the RM (and by extension the FFI) is required to conduct due diligence based on all information that is known to either the RM or the FFI, without regard to whether such information is contained within the client's account file.

The Notice requires the RM to perform a "diligent review" of the paper and electronic account files and other records for each client they serve, and

identify each client (including any associated family members) who, to the best of the RM's knowledge, has "U.S. indicia":

- U.S. citizenship or lawful permanent residence status (i.e., possesses a "greencard");
- A U.S. birthplace;[4]
- A U.S. residence address or U.S. correspondence address (including a U.S. post office box);
- Provided standing instructions to transfer funds to an account maintained in the United States;
- The FFI sends correspondence regularly to a U.S. address, an "in care of" address or a "hold mail" address (outside the United States) that is the client's sole address; or
- Granted power of attorney or signatory authority to a person with a U.S. address.

If the RM identifies any such client, the RM must then request a W-9 or a W-8BEN ("Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding") from the client. If the client provides a W-8BEN, the client must also provide certain proof that supports the client's non-U.S. status.[5] The due diligence required pursuant to Step 3 must be completed by the end of the first year that the FFI's Agreement is in effect.

The above documentation must be obtained from a client if the RM later becomes aware that a client has any of the U.S. indicia described above. A client's failure to respond to an RM's request for documentation will result in the FFI including the account in its U.S. account reporting or the FFI will be obligated to treat the account as a recalcitrant account.

Step 4: Electronic File Search to Test for U.S. Indicia in non-Private Banking Accounts Valued Less than $500,000

Step 4 imposes a due diligence regime that effectively tests for the same indicia required in the private banking context; however, the search is based on electronic records maintained in a searchable format and does not require

conducting a manual search or probing the knowledge of bank personnel.[6]

For purposes of the due diligence required in Step 4 of the Notice, an electronic records search means conducting a search of the information that the FFI maintains in its tax reporting files, customer master files, or similar files, which are stored in a searchable electronic database. As in Step 3 above, if the account has U.S. indicia, the FFI must request certain documentation to establish whether the account is a U.S. account as outlined above; however, the Step 4 test utilizes a slightly different list of U.S. indicia than what is used in Step 3.

Step 5: Enhanced Due Diligence for High Value Accounts

Step 5 requires enhanced due diligence for accounts of $500,000 or more that were not identified in Steps 1 through 4. For these accounts, the FFI must perform a "diligent review" of the account files associated with the account. If U.S. indicia (as listed in Step 4) are found, the FFI must obtain the appropriate documentation (as described above in Step 4) within two years of the FFI Agreement's effective date. Presumably, a diligent review is similar to the review described in Step 3; requiring an RM to review paper, electronic account files and other records. It is unclear if a diligent review for these purposes requires the FFIs to assess their employees' knowledge of the account holders.

Step 6: Annual Retesting for High Value Accounts

Step 6 requires the FFI to retest annually beginning the third year after the FFI Agreement's effective date. Retesting involves applying Step 5 to all preexisting individual accounts that would have met the $500,000 threshold if they had been tested on the last day of the year.

In lieu of audit procedures, the IRS intends that the FFI's chief compliance officer will certify that the FFI has accomplished the due diligence review required pursuant to the Notice. The due diligence review and associated certification of Steps 1 through 3 must be made within one year after the effective date of the FFI Agreement. The remaining steps must be completed, and the associated certification made, within two years after the effective date of the FFI Agreement.

More importantly, the FFI's chief compliance officer must also certify that between April 9, 2011 (the publication date of the Notice) and the effec-

tive date of the FFI Agreement, FFI personnel did not engage in any activity, or have any formal or informal policies and procedures in place, directing, encouraging, or assisting account holders with respect to strategies for avoiding identification of their accounts as U.S. accounts. This broad prohibition is likely to raise industry concerns and require the IRS to clarify specifically what type of conduct is prohibited (e.g., prohibit the exiting of U.S. accounts prior to the effective date of the FFI Agreement).

Finally, the chief compliance officer is required to certify that as of the FFI Agreement's effective date, the FFI had written policies and procedures in place that prohibit its employees from advising U.S. account holders on how to avoid having their U.S. accounts identified.

The IRS is considering whether to expand Step 3's due diligence to other types of accounts the FFI maintains, in particular to other preexisting accounts outside the private banking context, including certain insurance policies.

PASSTHRU PAYMENT RULES

In General

Section II of the Notice provides guidance on the term "passthru payment" for purposes of Chapter 4 of the Code. Generally, a participating FFI is required to deduct and withhold a tax equal to 30 percent of any passthru payment made to a recalcitrant account holder or non-participating FFI.[7] A "passthru payment" is defined as any withholdable payment or payment to the extent attributable to a withholdable payment.[8] The Notice provides guidance on determining whether a payment is attributable to a withholdable payment in the context of a payment made by an FFI with respect to its own non-publicly traded securities (e.g., generally in the context of a fund) or a payment made to an FFI that holds investments for a client as a custodian.

Commentators requested that Treasury and the IRS define passthru payments narrowly, such that only payments directly traceable to a withholdable payment would be considered a passthru payment. Treasury and the IRS rejected this test because it would permit investors to avoid FATCA's withholding tax by directly investing in an FFI "blocker entity" that invests in an FFI that derives U.S. source income. Instead, Treasury and the IRS implemented procedures that are remarkably complex, and which may be difficult to administer.

As a general matter, the passthru payment rules have the effect of resourcing non-U.S. source income paid by an FFI that is a non-U.S. investment fund to its investors (or, in the case of an FFI that holds assets as a custodian, paid by such FFI to the account holder) such that it would be treated as U.S. source income subject to FATCA's withholding tax in proportion to the so-called passthru payment percentage ("PP%") of the FFI.

The PP% is the ratio of the FFI's "U.S. assets" to its "total assets."[9] It must be determined quarterly and made publically available.[10] If a participating, or deemed-compliant, FFI fails to timely calculate or publish its PP%, the PP% is deemed to be 100 percent, resulting in the entire payment being treated as subject to FATCA withholding tax.[11] An anti-abuse rule prohibits an FFI from selling assets prior to the quarterly testing date and re-acquiring the same assets immediately following the testing date.

Regarding the calculation of the PP%, many implementation details need to be worked through such that FFIs and others that may be required to calculate the PP% do so consistently.[12] This includes using consistent accounting methods and criteria for including assets. The Notice requests comments as to whether alternative methods are more appropriate and administrable under particular circumstances.

The Notice also requests comments on possible exemptions from the definition of passthru payment that would be consistent with the policy goals of the passthru payment rule, but also reasonable in light of the potential burden to FFIs.

Custodial Payments

The Notice defines the term "custodial payment" as a payment with respect to which an FFI acts as a custodian, broker, nominee, or otherwise as an agent for another person. In a case where an FFI receives a custodial payment (the "FFI custodian"), the FFI custodian may be required to treat the payment as a passthru payment (i) to the extent that the payment is a withholdable payment that is paid to the FFI custodian that is obligated to be credited to the account of a recalcitrant account holder or nonparticipating FFI, or (ii) if the payment is made with respect to an interest or instrument issued by another FFI (the "issuer FFI"). Where the payment is a withholdable payment in the hands of the FFI custodian, the FFI custodian must apply the FATCA

withholding tax at a 30 percent rate unless tax was withheld by another withholding agent. On the other hand, in the case where the payment is made by an issuer FFI, the FFI custodian would be obligated to treat the payment as a passthru payment by reference to the PP% of the issuer FFI (and not by reference to its own PP%).

The Notice provides examples of the operation of this rule. Where the custodial payment is, itself, a withholdable payment—such as dividends paid with respect to stock of a U.S. corporation—the custodial FFI must treat the dividend payment as a passthru payment when credited to the account of a recalcitrant account holder. Similarly, where a broker that is an FFI holds, as custodian for a recalcitrant account holder, an interest in an FFI that is an investment fund, payments made with respect to the interest in the FFI investment fund will be treated as a passthru payment and tax would be withheld subject to the PP% of the FFI investment fund. Payments made by non-financial foreign entities to an FFI custodian should not be treated as passthru payments to the extent that such payments do not constitute a withholdable payment.

Other Payments

In the case of any payment by an FFI other than a custodial payment, the portion of such payment treated as a passthru payment would be made by reference to the PP% of the payor FFI. Accordingly, an FFI that makes a payment with respect to its own non-publicly traded stock or debt would be obligated to apply its own PP% to determine the portion of its payment that constitutes a passthru payment in the hands of a recalcitrant account holder or non-participating FFI.

DEEMED-COMPLIANT STATUS

Section III of the Notice provides procedural guidance regarding obtaining deemed compliant FFI status and expands the categories of FFIs that will be considered deemed compliant FFIs pursuant to Section 1471(b)(2).

In order to qualify as a deemed-compliant FFI, the FFI will be required to (i) apply for such status with the IRS, (ii) obtain an FFI identification number ("FFI-EIN") that identifies it as a deemed-compliant FFI, and (iii)

certify every three years that it meets the requirements for such status. It is possible that the IRS may provide additional substantive or verification procedures that are intended to ensure that a deemed-compliant FFI appropriately qualifies for such status.

The Notice provides two safe harbors for "local" FFIs that may qualify for deemed-compliant FFI status. These safe harbors would apply only where the FFI does not conduct any operations outside of its country of organization and does not solicit customers outside of its country of organization; therefore, they may be of limited practical use, unless the bank is truly local. Recently, Treasury and IRS personnel have informally stated that these requirements may be further modified.

The Notice also provides guidance regarding certain investment vehicles that will qualify as deemed compliant FFIs. A collective investment vehicle will be considered to be a deemed-compliant FFI if (i) all direct holders of record are either participating FFIs or deemed-compliant FFIs, (ii) the collective investment vehicle prohibits the acquisition of interests in the vehicle by any person that is not a participating FFI, a deemed-compliant FFI or an entity exempt from FATCA, and (iii) the vehicle certifies that any PP% that it calculates and publishes will be in accordance with the rules of the Notice.

Treasury and the IRS are continuing to consider whether other investment vehicles, the interests of which are regularly traded on an established securities market (e.g., exchange traded funds) could be considered deemed-compliant. Treasury and the IRS have suggested that a publicly traded fund that does not maintain financial accounts to which FATCA withholding tax could apply, would nevertheless be obligated to enter into an FFI agreement with the IRS (or satisfy the procedures to obtain deemed-compliant FFIs status), publish its PP%, and be obligated to withhold on any passthru payments it makes to non-participating FFIs. Forthcoming guidance will provide when certain foreign retirement plans or retirement accounts may be deemed-compliant.

REPORTING ON U.S. ACCOUNTS

Section IV of the Notice provides guidance with respect to U.S. accounts which modifies the proposed FFI reporting requirements previously outlined

in Notice 2010-60. Notice 2010-60 required an FFI that chose to conduct account balance reporting, to report to the IRS the highest month-end account balance during the year for U.S. deposit and custodial accounts. In addition, the FFI was required, upon request, to provide additional documents related to the balance amounts (e.g. copies of account statements, including monthly or quarterly balances and daily receipts and withdrawals).

Commentators noted that because FFIs did not contain many of these records significant costs would be incurred in order to comply. Based on these comments the Notice states that forthcoming guidance is intended to clarify that the account balance reporting requirements will be limited to year-end account balances or values as determined for purposes of reporting to the account holder.

In light of comments suggesting ways to ease the burden regarding the reporting of gross receipts and gross withdrawals made to and from U.S. accounts, the Notice states that regulations will provide for annual reporting of (i) the gross amount of dividends, interest or other income paid or credited to the account and (ii) the gross proceeds from the sale or redemption of property paid or credited to the account with respect to which the FFI acted as a custodian, broker, nominee or agent for the account holder. The FFI must choose a method to determine the amount and character of the payments and apply the method consistently for all account holders. The Notice also specifies that guidance will provide that FFI's that are non-U.S. payors will not have to report cost basis information with respect to their U.S. accounts.

QUALIFIED INTERMEDIARIES

Section V of the Notice provides that those FFIs that are also qualified intermediaries ("QIs") will have their QI Agreements modified such that they will be deemed to have entered into an FFI Agreement as of January 1, 2013. Accordingly, a QI will be treated as a participating FFI, unless the QI applies for deemed-compliant FFI status and complies with the procedures associated with such status. Treasury and the IRS intend to issue future guidance that will harmonize a QI's obligations pursuant to Chapter 3 (nonresident alien withholding) and Chapter 4 (FATCA) of the Code.

EXPANDED AFFILIATED GROUPS

Section VI of the Notice provides guidance regarding Section 1471's application to expanded affiliated groups of FFIs ("FFI Group") under Section 1471(e).[13] The Notice states that Treasury and the IRS intend to issue regulations under Section 1471(e) that would require each FFI affiliate in an FFI Group to be a participating FFI or a deemed-compliant FFI. Treasury and IRS continue to study whether and under what conditions it may be possible to allow an FFI Group to include one or more non-participating FFI affiliates.

Pursuant to this rule, an FFI Group may determine which of its affiliates will become participating FFIs. Accordingly, an FFI Group may begin to consider strategies to mitigate group-wide risks associated with FATCA by focusing due diligence burdens on affiliates that have U.S. accounts, and by minimizing burdens with respect to those affiliates that do not have such accounts.

In order to minimize U.S. securities law risks associated with providing securities brokerage and/or advisory services to U.S. persons, FFI Groups may also consider whether participating FFIs might benefit from, or warrant, U.S. registration (e.g., as an investment adviser registered with the U.S. Securities and Exchange Commission), particularly in light of restrictive changes being made to previously available registration exemptions by the Dodd-Frank Act. Similarly, FFIs offering non-securities services (e.g., brokering trades in foreign currency futures) to U.S. persons should consider the potential application of other U.S. financial services regulations.

The Notice also permits each participating FFI within an FFI Group to be responsible for its own due diligence and compliance pursuant to its own FFI Agreement. However, the Notice also provides that an FFI Group may designate a single affiliate FFI to act as "lead" FFI to coordinate compliance among FFI affiliates within the FFI Group and to serve as the IRS's point of contact for the FFI Group.

Similarly, the Notice suggests that a single affiliate within the FFI Group could assume an active compliance role for one or more FFI affiliates within the affiliated group.

EFFECTIVE DATE

Section VII of the Notice specifies that FFI Agreements will become effective on the later of: (i) the date they are executed or (ii) the effective date of Section 501 of the HIRE Act (which applies to payments made after December 31, 2012).

NOTES

[1] Notice 2011-34, 2011-19 I.R.B. 765 (Apr. 8, 2011). The term "FATCA" is an acronym referring to the Foreign Account Tax Compliance Act of 2009, proposed legislation which was substantially incorporated into Subtitle A of Title V of the Hiring Incentives to Restore Employment (the "HIRE Act"). Pub. L. No. 111-147 (Mar. 18, 2010).

All references herein, unless specified, are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder.

[2] Notice 2010-60, 2010-37 I.R.B. 329 (Aug. 27, 2010).

[3] Account holders of jointly held accounts will be attributed the full balance or value of the joint account for purposes of determining the combined balance or value of that account holder's associated accounts.

[4] If the client has a U.S. birthplace the RM must obtain a written statement from the client regarding his or her renunciation of U.S. citizenship.

[5] All written requests related to this search must be retained by the FFI for 10 years.

[6] As a preliminary matter, it is not entirely clear whether this requirement would require retesting of the accounts ("[f]rom among the accounts that are not identified as U.S. accounts in Step 1…").

[7] Section 1471(b)(1)(D).

[8] Section 1471(d)(7); *see also* Section 1473(1)(A) (defining the term "withholdable payment" as "(i) any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income, if such payment is from sources within the United States, and (ii) any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from sources within the United States.")

[9] As a general matter, an FFI's total assets include the gross value (unreduced by liabilities or other obligations) of: (i) all balance sheet assets, and (ii) to the extent provided in future guidance off-balance sheet assets. Assets would be valued pursuant to valuations used on quarterly financial statements or, if no quarterly financial

statements are produced, on the most recently issued financial statement. Total assets, however, exclude assets held in custodial accounts of the FFI.

An FFI's U.S. assets include all assets to the extent such assets could give rise to a passthru payment (e.g., stock that produces U.S. source income, interests in an FFI that directly own stock that produces U.S. source income or, interests in an FFI that indirectly owns (through another FFI) stock that produces U.S. source income). For this purpose, stock of a non-financial foreign entity is treated as a non-U.S. asset, without regard to whether such stock could give rise to a passthru payment. Obligations that are exempt from FATCA withholding by reason of the so-called grandfathered obligation rule are not treated as U.S. assets for purposes of determining an FFI's PP%.

[10] An alternative transition method for calculating PP% is also provided in the Notice. This method would effectively permit an FFI to determine its PP% using a blended rate over a specified period.

[11] The PP% for a non-participating FFI is 0, presumably so that no additional withholding tax is imposed on the payment to a non-participating FFI or recalcitrant account holder further up the chain of payment.

[12] For instance, guidance is needed to address payments made after FATCA's December 31, 2012 effective date and the first quarter of 2013 when FFIs would be first required to publish their PP%.

[13] Section 1471(e) defines an expanded affiliated group by reference to the Section 1504 affiliated group rules but utilizes a more than 50 percent test of ownership (by vote or value), in lieu of the at least 80 percent test used in Section 1504. Partnerships and other non-corporate entities may be treated as part of the expanded affiliated group if more than 50 percent (by value) of the beneficial interests in the entity is directly or indirectly owned by a member of the expanded affiliated group.