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Key Aspects of the FATCA Regime

The US withholding and information reporting regime under the Foreign Account Tax Compliance Act of 2010 (“FATCA”),¹ when implemented, will affect a broad range of foreign entities, both financial and non-financial, and US withholding agents. Recently, the Treasury Department and Internal Revenue Service (“IRS”) of the United States issued proposed regulations (“Proposed Regulations”)² implementing FATCA. Although the Proposed Regulations are subject to change, foreign financial entities should not wait to assess the impact of FATCA, because compliance with FATCA will require substantial systems changes. In particular, foreign financial entities should assess the need to enter into an agreement with the IRS, with its resulting obligations, in order to avoid any potential withholding under FATCA currently scheduled to begin January 1, 2014.

The Treasury Department also issued a joint statement with the governments of Germany, the United Kingdom, France, Italy, and Spain indicating their intention to develop an intergovernmental approach to implementing FATCA and improving tax compliance. Various other countries have undertaken, or indicated an intention to undertake, discussions with the Treasury Department to reach such an intergovernmental agreement.

This memorandum provides an overview of the applicable rules and requirements to help foreign entities and US withholding agents in determining whether they are subject to the FACTA requirements. It also discusses various implications of the Joint Statement.

¹ FATCA was signed into law on March 18, 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act, P.L. 111-47 (2010).

² RIN 1545-BK68, 77 Fed. Reg. 9022 (February 15, 2012).

Background

In principal part, FATCA³ targets offshore tax evasion by imposing substantial gross withholding on a large class of “withholdable payments” unless the recipient agrees to specific undertakings designed to identify US owners.

The FATCA rules essentially require a “foreign financial institution” (“FFI”) to enter into, and to comply with, a reporting and withholding agreement (“FFI Agreement”) with the IRS with respect to US account holders. An FFI that enters into an FFI Agreement is referred to as a “Participating FFI.” An FFI that does not enter into an FFI Agreement (referred to as a “Non-Participating FFI”) would be subject to a 30% gross withholding tax on withholdable payments, unless it is otherwise exempted from the FATCA regime.

Foreign entities that are not FFIs (“NFFEs”) and that do not qualify for an exemption will be subject to less demanding requirements to avoid FATCA withholding on withholdable payments. An NFFE will be required to provide the withholding agent with the name, address and TIN of each of its “substantial US owners,”⁴ or to certify that it does not have any substantial US owners.

Pursuant to an FFI Agreement, a Participating FFI generally must agree to collect and report to the IRS information with respect to (1) US persons that hold “financial accounts” and (2) substantial US owners of certain NFFEs, unless certain exceptions apply with respect to the account or the payee. In addition, a Participating FFI must agree to withhold on payments to Non-Participating FFIs and “recalcitrant account holders,” i.e., those that do not provide the information that the Participating FFI is required to furnish to the IRS under its FFI Agreement.

The IRS has not yet published the form (or forms) of an FFI Agreement. The preamble to the Proposed Regulations states that this form is expected to be published by the IRS in a Revenue Procedure in early 2012 and will be finalized by the autumn of 2012. The FFI Agreement would include provisions specifying the FFI’s obligations with respect to withholding; identification and documentation of account holders; reporting; expanded affiliated groups; waivers; verification; events of default; and requests for additional information. The Proposed Regulations do not change the previously announced deadlines for entering into an FFI Agreement. According to Notice 2011-53,⁵ the IRS will begin accepting applications for FFI Agreements on January 1, 2013, and an FFI must enter into an FFI Agreement by June 30, 2013 to ensure that it will be identified as a Participating FFI when FATCA withholding is scheduled to begin to apply on January 1, 2014.⁶

Part I of this memorandum describes which FFIs and NFFEs are subject to FATCA. Part II describes the withholding, reporting, and due diligence requirements that FATCA imposes on Participating FFIs and US withholding agents. Part III describes the framework for bilateral or multilateral intergovernmental agreements outlined in a joint statement, issued by the Treasury Department and the governments of Germany, the United

³ The statutory provisions of FATCA constitute the new chapter 4 (Sections 1471 to 1474) of subtitle A of the Internal Revenue Code of 1986, as amended (“Code”). Section references in this memorandum are to the Code, unless otherwise indicated.

⁴ As described in more detail in Section II.3.b below, a “substantial US owner” of a foreign entity is any “specified US person” with (1) a greater than 10% ownership interest in the entity or (2) in the case of, e.g., an investment vehicle that is an FFI, or an insurance company, any equity interest in the entity.

⁵ 2011-31 I.R.B. 124.

⁶ FFIs entering into an FFI Agreement after June 30 but before January 1, 2014 would qualify as Participating FFIs but might not be identified as such to prevent initial FATCA withholding. Participating FFIs entering into an FFI Agreement during that period would need to rely on the FATCA refund procedures to obtain a refund (or credit, if applicable) for amounts withheld pursuant to FATCA.

Kingdom, France, Italy, and Spain at the same time as the Proposed Regulations were released, indicating their intention to develop an intergovernmental approach to implementing FATCA and improving tax compliance. Part IV summarizes the current time line for the phased implementation of FATCA.

I. Foreign Entities Subject to FATCA

This Part begins by describing which entities are “foreign financial institutions.” It then discusses which FFIs are exempt from the requirement to enter into an FFI Agreement. Finally, it discusses which NFFEs are subject to FATCA and summarizes the rules that apply to NFFEs.

1. Foreign Financial Institutions

FFIs are foreign entities that:

- accept deposits in the course of a banking or a similar business;⁷
- hold financial assets for the account of others as a substantial portion of their business;⁸
- are foreign investment entities, i.e., entities that are engaged (or holding themselves out to be engaged) primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities, notional principal contracts, insurance or annuity contracts, or any interest (including a futures or forward contract or option) in such security, partnership interest, commodity, notional principal contract, insurance contract or annuity contract;⁹ or
- are insurance companies that issue investment-like insurance contracts or annuity contracts.

This definition is broad and encompasses, among others, entities such as private equity funds, hedge funds, family investment vehicles, and other investment vehicles that would not typically be considered to be financial institutions.

2. Foreign Financial Institutions That Are Not Required to Enter into an FFI Agreement to Avoid FATCA Withholding

There are generally three classes of FFIs that are not required to enter into an FFI Agreement to avoid FATCA withholding. These are: “excepted” FFIs, “deemed-compliant” FFIs and FFIs that are “exempt beneficial owners.”

⁷ An entity is engaged in a “banking or similar business” if, in the ordinary course of its business with customers, the entity engages in one or more of the following activities: accepting deposits of funds; making personal, mortgage, industrial or other loans; purchasing, selling, discounting, or negotiating accounts receivable, installment obligations, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness; issuing letters of credit and negotiating drafts drawn thereunder; providing trust or fiduciary services; financing foreign exchange transactions; entering into, purchasing, or disposing of finance leases or leased assets; or providing charge and credit card services.

⁸ An entity falls into this category if its gross income attributable to the holding of financial assets and related financial services equaled or exceeded 20% of its gross income during the three-year period ending on the last day of the calendar year in which the determination is made (or the period of the entity’s existence, if shorter).

⁹ An entity is so categorized if its gross income attributable to investing, reinvesting or trading amounted to at least 50% of its gross income during the three-year period ending on the last day of the calendar year in which the determination is made (or the period of the entity’s existence, if shorter).

a. Excepted Foreign Financial Institutions

Certain classes of foreign financial entities are excluded from the definition of FFI (“excepted FFIs”). These include certain nonfinancial holding companies, certain start-up companies, nonfinancial entities that are liquidating or emerging from reorganization or bankruptcy, hedging or financing centers of a nonfinancial group and certain not-for-profit organizations. Investment funds, however, would not qualify for any of these exceptions.¹⁰

b. Deemed-Compliant Foreign Financial Institutions

Deemed-compliant FFIs are not required to enter into an FFI Agreement. There are two categories of deemed-compliant FFIs, “registered” and “certified”:

- **Registered Deemed-Compliant FFIs** are required to certify to the IRS that they will comply with certain procedural requirements and will renew this certification every three years and whenever there is a change in the FFI’s circumstances. To be eligible to become a registered deemed-compliant FFI, an FFI must be:
 - a local FFI, which generally includes any FFI licensed and regulated under the laws of its country of organization as a bank or similar organization, with no fixed place of business outside that country, with accounts almost exclusively for residents of that country, and with policies and procedures in place to ensure that it does not open or maintain accounts for a US person or an NFFE subject to FATCA reporting and withholding;
 - a nonreporting member of a Participating FFI group;¹¹
 - a qualified collective investment vehicle, i.e., an entity engaged in investing, reinvesting, or trading that is regulated in the country of its incorporation as an investment fund and whose holders of equity, holders of debt in excess of \$50,000, and other financial account holders of record are generally limited to Participating FFIs, registered deemed-compliant FFIs, US persons that are excepted from being treated as substantial owners of NFFE (see below) and exempt beneficial owners (see below);
 - a restricted fund, i.e., a foreign investment entity regulated as an investment fund under the laws of the country (which must be FATF-compliant)¹² in which it is organized or incorporated; interests in the fund may be sold only through certain compliant distribution channels and only under distribution agreements that prohibit sales to US persons, Non-Participating FFIs, and certain types of NFFEs; and the fund must also comply with certain account identification and account redemption rules; or
 - an FFI that is deemed to comply with the FATCA information reporting requirements pursuant to an agreement between the United States and a foreign jurisdiction (see [Part III](#)).

¹⁰ Excepted FFIs also would not be NFFEs, i.e., their exception from FFI status would not turn them into NFFEs.

¹¹ A Participating FFI group is an affiliated group that includes one or more Participating FFIs, if the nonreporting member meets requirements intended to ensure that it does not maintain US accounts.

¹² This requires the country to meet certain standards of the Financial Action Task Force, which is an intergovernmental body that develops and promotes policies to combat money laundering, the financing of terrorism and proliferation of weapons of mass destruction.

- **Certified Deemed-Compliant FFIs** are not required to register with the IRS but instead must certify to a withholding agent on an IRS Form W-8 that they meet the applicable requirements. This category includes:
 - nonregistering local banks, i.e., any FFI that is licensed and operates solely as a bank and solely in its country of organization, is engaged primarily in the business of making loans and taking deposits from retail customers, does not solicit account holders outside of its country of organization, and has no more than \$175 million in assets on its balance sheet (or \$500 million in assets on the combined balance sheet of its expanded affiliated group);
 - retirement funds, i.e., any FFI that is organized for the provision of retirement or pension benefits and meets certain other requirements;
 - non-profit organizations, i.e., any FFI that is established and maintained in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, is exempt from tax in its country of residence, and meets certain other requirements; and
 - FFIs with only low value accounts, i.e., any FFI (other than an investment vehicle or an insurance FFI) that does not, and whose expanded affiliated group does not, maintain any accounts with a value in excess of \$50,000 and whose expanded affiliated group has no more than \$50 million in assets.

In addition, “owner-documented FFIs” may be certified deemed-compliant but only with respect to a specific withholding agent, which must be a US financial institution or Participating FFI that has agreed to undertake additional due diligence and reporting obligations. Owner-documented FFIs are foreign investment entities that are not affiliated with any other FFI (other than a foreign investment entity), do not maintain any financial account for any Non-Participating FFI, and do not issue debt (unless regularly traded on an established securities market) to any person in excess of \$50,000. An owner-documented FFI generally is required to submit to its designated withholding agent all due diligence documentation required by the IRS, which the withholding agent would then report to the IRS.

If an FFI is part of an expanded affiliated group, all members of the expanded affiliated group (generally based on more than 50% by vote and value common stock ownership), and controlled partnership entities, that are FFIs must be Participating FFIs or deemed-compliant FFIs in order for any member to become a Participating FFI or deemed-compliant FFI (in particular, a nonreporting member of a Participating FFI group). The Proposed Regulations provide for a two-year transition period, ending on January 1, 2016, for certain “limited branches” and “limited FFI affiliates,” before this requirement will be fully implemented. Such limited branches and affiliates would need to satisfy several conditions to qualify for this transition rule, including that the failure to qualify is due to restrictions under applicable law, and would themselves remain subject to FATCA withholding.

c. Exempt Beneficial Owners

A statutory exemption from FATCA withholding applies to a beneficial owner that is:

- a foreign government, a political subdivision of a foreign government, or a wholly owned agency or instrumentality of a foreign government (together, “foreign governments”);
- an international organization, or a wholly owned agency or instrumentality of an international organization; or
- a foreign central bank of issue.

The Proposed Regulations add to these classes of “exempt beneficial owners” by including certain foreign retirement funds and investment entities wholly owned by one or more other exempt beneficial owners.

The exemption for retirement funds applies to a fund that is either:

- established in a country that has an income tax treaty with the United States, generally exempt from income taxation in that country, operated principally to administer or provide pension or retirement benefits, and entitled to benefits under the treaty on US source income; or
- formed for the provision of retirement or pension benefits under the law of the country in which it is established and generally exempt from taxation (or otherwise receiving 50% or more of its contributions from specified sources), provided it receives its contributions from government, employer or employee contributions (limited by reference to earned income) and does not have a single 5% or larger beneficiary.

The exemption for foreign governments is available for any “integral part” of a foreign government and entities that are (directly or indirectly) wholly owned and controlled by one or more foreign governments. Unlike Section 892, the exemption from FATCA withholding for a wholly owned government entity applies regardless of whether the entity is engaged in, or the income is derived from, the conduct of commercial activities. Thus, a “sovereign wealth fund” generally is not required to enter into an FFI Agreement. The exemption, however, does not apply to a wholly owned entity that is a financial institution engaged in a banking or custodial business.

3. Application of Rules Relating to Foreign Financial Institutions

Investment Funds. Foreign private equity funds, hedge funds, and similar investment funds, other than investment funds wholly owned and controlled by foreign sovereigns, are FFIs that must enter into FFI Agreements to avoid FATCA withholding on withholdable payments. This also is the case for foreign feeder funds, alternative investment vehicles, parallel funds, and foreign blocker entities organized in connection with such foreign investment funds or US funds. Typical “sovereign wealth funds,” however, generally are not required to enter into FFI Agreements because they should qualify as exempted beneficial owners.

Securitization Vehicles. Non-US securitization vehicles are FFIs and are not excepted FFIs. Debt and equity interests issued by offshore securitization vehicles therefore are financial accounts for FATCA purposes (see section II.3 below), unless regularly traded on an established securities market. If a non-US securitization vehicle does not qualify as an owner-documented FFI (and thus a certified deemed-compliant FFI) it will have to enter into an FFI Agreement to avoid FATCA withholding on withholdable payments. However, as described in more detail below, a non-US securitization vehicle could substantially reduce its FATCA compliance burden with respect to interests that are held by Participating FFIs, US clearing organizations or other US financial institutions.

Treasury and the IRS have asked for comments on whether it is appropriate to treat as grandfathered obligations equity interests in a securitization vehicle that invests solely in debt and similar instruments if such vehicle will liquidate within a specified time frame.

4. Application of FATCA to Non-Financial Foreign Entities

An NFFE must either (1) identify its substantial US owners,¹³ or (2) if it does not have substantial US owners, certify that to an applicable withholding agent, in order to avoid FACTA withholding on withholdable payments. An NFFE would include any foreign entity that is not an FFI. However, FATCA withholding, and thus the obligation to certify, would not apply to “excepted NFFEs.” Excepted NFFEs are:

¹³ The criteria for being a substantial US owner are discussed in section II.3.b below.

- corporations that are publicly traded on an established securities market and members of their expanded affiliated group;¹⁴
- “active NFFEs,” i.e., NFFEs less than 50% of whose gross income for the preceding calendar year is passive income or less than 50% of whose assets during the preceding calendar year produce, or are held for the production of, passive income;
- “territory NFFEs,” i.e., entities directly or indirectly wholly owned by one or more bona fide residents of the same US possession under the laws of which the entity is organized; and
- entities that are exempt beneficial owners, as described above in section I.2.c.

The exception for publicly traded corporations applies only to corporations that are non-financial entities, i.e., not FFIs. The exception generally would not apply to (foreign) publicly traded partnerships.

II. FATCA Obligations of US Withholding Agents and Participating Foreign Financial Institutions

This Part sets forth the requirements that FATCA imposes on US withholding agents and Participating FFIs, beginning with withholding obligations and the definition of withholdable payments. It then describes FATCA reporting requirements and the implementation schedule for these requirements, and it ends with a discussion of due diligence obligations.

1. Withholding Obligations of US Withholding Agents and Participating Foreign Financial Institutions

a. Withholding

US withholding agents generally must deduct and withhold tax at a 30% rate on:

- any “withholdable payment” (described in the next section) made to a Non-Participating FFI that is not an excepted FFI, deemed-compliant FFI or exempted beneficial owner;
- any “withholdable payment” made to an NFFE that fails to appropriately certify that it is an excepted NFFE or, if it is not an excepted NFFE, fails to provide information regarding its substantial US owners or to certify that it has no substantial US owners; and
- withholdable payments of US source FDAP income made to a Participating FFI acting as an intermediary (other than a withholding qualified intermediary (“QI”)), or a flow-through entity (other than a withholding foreign partnership or withholding foreign trust), except to the extent the Participating FFI provides the withholding agent with valid documentation that establishes the portion of the payment that is allocable to a class of payees for which no withholding is required.¹⁵

¹⁴ A corporation is “publicly traded” if its stock is regularly traded on one or more established securities markets. See section II.3 below for definitions of “regularly traded” and “securities market.” See section 2 above regarding the definition of expanded affiliated group.

¹⁵ “FDAP” income is any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, and other fixed or determinable annual or periodic gains, profits, and income.

Participating FFIs are required to deduct and to withhold tax at a 30% rate on any “passthru payment” to a Non-Participating FFI or a recalcitrant account holder.¹⁶ Passthru payments include, in addition to withholdable payments, other payments “attributable to a withholdable payment.”¹⁷ The Proposed Regulations, however, would currently require such FATCA withholding only with respect to withholdable payments. Treasury’s approach in Notice 2011-34 to payments “attributable to” withholdable payments was met with widespread criticism. The Proposed Regulations currently reserve on the definition of “foreign passthru payments,” which is apparently intended to address payments by a Participating FFI that are “attributable to” withholdable payments. Withholding on foreign passthru payments would not be required before January 1, 2017 at the earliest.

In the preamble to the Proposed Regulations, the IRS and Treasury request comments regarding the reduction of the compliance burden created by foreign passthru payments, such as an election by the Participating FFI to rely on safe harbors in determining a percentage of payments to be treated as a foreign passthru payment instead of requiring the Participating FFI to calculate such a percentage on a regular basis.

b. Identification of Payees

Whether a withholding agent is required to withhold under FATCA depends on the identity of the payee. Generally, a withholding agent must base its determination of a payee’s status on documentation that the withholding agent can reliably associate with such payment. The payee generally is the person to whom a payment is made or the holder of the financial account to which a payment is made, but there are some exceptions.

For a payment made to an NFFE that is acting as an intermediary (i.e., as a custodian, broker, nominee, or otherwise as an agent for another person) with respect to the payment, the payee is the person for whom the NFFE collects the payment.¹⁸ Consistent with current non-FATCA withholding, a Participating FFI acting as an intermediary (other than a withholding QI) is not treated as the payee of any withholdable payment of US source FDAP income. In other cases, an FFI that is not a foreign flow-through entity is generally treated as the payee. A foreign flow-through entity, however, is treated as a payee only if it is (1) a Participating FFI receiving payment of US source FDAP, (2) an excepted FFI, (3) an active NFFE or (4) a withholding foreign partnership or withholding foreign trust that is not acting as an intermediary with respect to the payment. In other cases, the payee is the partner, beneficiary, or owner of the foreign flow-through entity. In addition, while most branches are not treated as payees, payments are treated as made to a US person for FATCA purposes if made (1) to a foreign branch of a US person or (2) to a US branch of a Participating FFI if reliable documentation indicates that the branch is treated as a US person for purposes of the backup withholding rules.

¹⁶ A “recalcitrant account holder” is an account holder that failed to provide the Participating FFI with the information necessary for the Participating FFI to determine whether the account holder is a US person, or other information which the Participating FFI is required to report to the IRS. Although there is a statutory requirement for the FFI to close any account maintained for a recalcitrant account holder in certain circumstances, the Proposed Regulations do not specify the conditions for doing so.

¹⁷ The Code provisions do not further elaborate on this concept. Notice 2011-34, 2011-19 I.R.B. 765, proposed to include among “passthru payments” (besides withholdable payments made by the Participating FFI in a custodial capacity) any non-custodial payments (such an interest payment on a savings account of a foreign bank) in proportion to the paying Participating FFI’s percentage of US assets (as defined in that Notice), which was to be determined on a quarterly basis.

¹⁸ Similarly, for a payment made to a US person acting as an intermediary for a foreign person, the foreign person is treated as the payee, except that a US financial institution that is acting as the intermediary is treated as the payee (unless the withholding agent has reason to know that the US financial institution will not comply with its FATCA withholding obligation).

c. Election

A Participating FFI that is a QI is able to make a “Section 1473(b)(3) election” to be withheld upon rather than to withhold on passthru payments otherwise subject to withholding by a Participating FFI. The Section 1473(b) election applies only to US source FDAP income (other than payments in respect of grandfathered obligations, as discussed below), and not to withholding on gross proceeds. Such an electing Participating FFI generally must provide pooled information to the withholding agent that indicates the portion of the payment attributable to recalcitrant account holders and Non-Participating FFIs and the portion of the payment that is allocated to each class of payees that is not subject to FATCA withholding. Where such allocation information is not provided, the withholding agent must presume that the entire portion of the withholdable payment that is US source FDAP income is made to Non-Participating FFIs and subject to FATCA withholding.

2. Withholdable Payments Subject to FATCA and Grandfathered Obligations

FATCA withholding applies only if “withholdable payments”¹⁹ are made to certain types of payees that have not agreed to provide required identifying information.

a. Withholdable Payments

“Withholdable payments” are:

- US source “FDAP” income (i.e., any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, and other fixed or determinable annual or periodic gains, profits, and income), with withholding beginning on January 1, 2014; and
- gross proceeds from the sale or other disposition (after December 31, 2014) of any property of a type which can produce interest or dividends from sources within the United States, with withholding beginning on January 1, 2015.

The definition of withholdable payments excludes:

- payments in respect of “grandfathered obligations,” as discussed below;
- payments on short-term debt obligations (having an original term to maturity of no more than 183 days);
- certain payments made in the ordinary course of a withholding agent’s business for nonfinancial services, goods and the use of property;²⁰
- sales of fractional shares of stock if the gross proceeds are less than \$20;
- gross proceeds from the sale of property that can produce income excluded from the definition of withholdable payment; and
- income taken into account as effectively connected with the conduct of a US trade or business.

¹⁹ These are referred to as “passthru payments” when made by a Participating FFI.

²⁰ Examples include ordinary course payments for wages, office and equipment leases, software licenses, transportation, and interest on outstanding accounts payable arising from the acquisition of nonfinancial services, goods, and other tangible property, but would not include dividends, other types of interest, certain dividend equivalent payments and bank or brokerage fees.

b. Grandfathered Obligations

FATCA exempts from FATCA withholding any “obligation” outstanding on March 18, 2012. The Proposed Regulations would extend this date and exempt from the definition of “withholdable payment,” and thus from potential FATCA withholding, any payment made under an “obligation” outstanding on January 1, 2013 as well as the gross proceeds from the disposition of such an obligation.

An “obligation” for this purpose is any legal agreement that could produce a passthru payment (i.e., a withholdable payment or a “foreign passthru payment,” once defined), except for any legal agreement or instrument that is treated as equity for US tax purposes and any legal agreement that lacks a stated expiration or term. The Proposed Regulations specify that “obligations” include debt instruments (as defined in the Code), a line of credit or revolving credit agreement with a fixed term to maturity and, as of its issue date, fixed material terms, a life insurance contract payable upon the earlier of attaining a stated age or death, a term annuity contract, and a derivatives transaction entered into between counterparties under an ISDA Master Agreement and evidenced by a confirmation.

An obligation that is indebtedness for US federal income tax purposes would be considered outstanding on January 1, 2013 if it has an “issue date” before January 1, 2013. Although the treatment of post-2012 “qualified reopenings” of a debt instrument (as defined in Treas. Reg. § 1.1275-2(k)(3)) issued before 2013 is not addressed in the Proposed Regulation, debt instruments issued pursuant to a qualified reopening may be treated as grandfathered obligations because their issue date is the same as that of the original debt instrument.

The Proposed Regulations would follow the approach of the existing Treasury Regulations to treat a debt instrument that is subject to a “material modification” (as defined in Treas. Reg. § 1.1001-3) as newly issued on the date of modification. Material modifications after December 31, 2012 of grandfathered debt instruments would therefore terminate their status as grandfathered obligations and render them subject to the FATCA withholding regime.

c. Preexisting Obligations

In addition, FATCA withholding will not apply to withholdable payments made before January 1, 2015 with respect to “preexisting obligations” for which a withholding agent does not have documentation indicating the payee’s status as a Non-Participating FFI, unless the payee is a *prima facie* FFI.²¹ A *prima facie* FFI, by contrast, must be treated as a Non-Participating FFI, i.e., subject to FATCA withholding, until it provides certification sufficient to establish otherwise. Preexisting obligations comprise accounts, instruments and contracts maintained or executed by the withholding agent as of January 1, 2013.

3. Target of FATCA Reporting Obligations: US Accounts

Participating FFIs are required to comply with due diligence procedures to identify “US accounts,” and also are required to annually report information about these accounts to the IRS.²² A US account is any “financial account” that is held by one or more “specified US persons” or “US-owned foreign entities.” US accounts exclude depository

²¹ A “*prima facie* FFI” is an entity that is designated in the withholding agent’s electronic (searchable) database as an account holder that is (1) a QI or a Nonqualified Intermediary, or (2) for accounts maintained in the United States, documented or presumed to be a foreign account holder and assigned in the withholding agent’s electronic (searchable) database one of a set of industry codes indicating that the entity is some kind of financial intermediary.

²² The reporting obligation are summarized in section 4 and the due diligence requirements in section 5 below.

accounts held solely by individuals, as long as the aggregate value of all bank accounts held by that individual at the same financial institution does not exceed \$50,000.²³

The holder of an account is the person or entity that is so identified or listed with the FFI, even if that person is a flow-through entity (with special rules applicable to certain grantor trusts). An agent, however, is not treated as holding the account, and each holder of a jointly held account is treated as the account holder in determining whether it is a US account.

For insurance contracts that qualify as financial accounts, the holder is the owner, if the owner can access the cash value of the contract or change a beneficiary under the contract. Otherwise, upon maturity of the contract, when the obligation to pay becomes fixed, each beneficiary of the contract is treated as the holder of the contract.

a. Financial Accounts

Financial accounts comprise, for this purpose, not only depository or custodial accounts maintained by the FFI, but also equity or debt instruments issued by the FFI that are not regularly traded on an established securities market (such as, for example, customary equity interests in a hedge fund or private equity fund) as well as cash value insurance contracts and annuity contracts issued or maintained by the FFI. However, an equity or debt interest in an FFI that is a bank, holds financial assets for the account of others, or is an insurance company is not treated as a financial account if its value is not determined primarily by reference to assets that give rise to withholdable payments, even if it is not regularly traded on an established securities market. In addition, financial accounts do not include certain retirement and pension accounts, or regulated savings plans for which contributions are limited by reference to earned income and may not exceed \$50,000 (or less) annually under the law of the jurisdiction in which the account is maintained, and that limit access and withdrawals.

A “securities market” generally includes most national exchanges, and interests are “regularly traded” if trades in the interest are effected (other than in *de minimis* quantities) on an established securities market on 60 or more days during the prior calendar year and the aggregate number of interests so traded during that period amounted to at least 10% of the average number of interests outstanding during that period.

b. Specified US Persons and US-Owned Foreign Entities

Specified US persons are US persons that do not belong to one of the following excluded classes:²⁴ (1) publicly traded corporations; (2) tax-exempt organizations; (3) individual retirement plans; (4) US governmental units; (5) banks; (6) REITs; (7) RICs; (8) common trust funds; (9) certain charitable or partially charitable trusts; (10) brokers required to furnish information returns to the IRS; and (11) dealers in securities, commodities, and derivatives that are registered under federal or US state law.

A US-owned foreign entity is any foreign entity with one or more substantial US owners. An entity, for purposes of the FATCA regime, generally is any person other than an individual. A substantial US owner is any specified

²³ An FFI may, however, elect not to exclude such accounts from its reporting.

²⁴ A US person, as defined for US tax purposes, is (1) any entity that is, for US tax purposes, a domestic corporation or domestic partnership, (2) and individual who is a US citizen or US resident for US tax purposes, (3) an estate if all of its gross income is includible in gross income for US tax purposes, or (4) a trust if a court within the United States is able to exercise primary supervision over its administration and one or more US persons have the authority to control all substantial decisions of the trust.

US person with a greater than 10% direct or indirect ownership interest in the foreign entity.²⁵ In the case of insurance companies and investment vehicles that are FFIIs, however, for example a private equity fund or a hedge fund, any specified US person with any interest in the entity is treated as a substantial US owner. Similarly, a US person treated as owing all or part of a grantor trust is treated as a substantial US owner without any threshold ownership percent. Further, any US owner of an owner-documented FFI is treated as a substantial US owner.

The Proposed Regulations clarify that an owner of an option is treated as owning the underlying asset. In addition, indirect ownership interests in foreign entities are generally determined on a proportionate basis, but (direct or indirect) ownership interests held directly or by attribution by a Participating FFI, deemed-compliant FFI (other than an owner-documented FFI), US financial institutions, or certain other entities, are not attributed further.

4. FATCA Reporting by Participating Foreign Financial Institutions

FATCA requires Participating FFIs to provide annual information reports to the IRS with respect to accounts that are identified as US accounts.

Expanding on Notice 2011-53, the Proposed Regulations implement this FATCA information reporting on a phased-in schedule. The first two FATCA information reports, for the calendar years 2013 and 2014, must include only the account holder's name, address, TIN and account balance. The reports will be due on March 31 of the year following the respective reporting year. The report for the calendar year 2015 (and all subsequent reports) in addition must include the income associated with the US account. The reports for 2016 and all future calendar years must also include the gross proceeds associated with the US account.

In addition to these reports on US accounts, Participating FFIs also must report the aggregate number and aggregate value of accounts held by recalcitrant account holders at the end of the respective calendar year. This reporting must be subdivided into (1) accounts that have indicia of US status, (2) accounts that do not have indicia of US status and (3) dormant accounts.

The Proposed Regulations also require reporting of the aggregate amount of "foreign reportable amounts" paid by a Participating FFI to a Non-Participating FFI for 2015 and 2016. The Proposed Regulations currently limit foreign reportable amounts to FDAP income that would have been a withholdable payment if paid by a US person, such as interest and dividends on non-grandfathered obligations of the Participating FFI.

5. Due Diligence Obligations of Participating Foreign Financial Institutions and US Withholding Agents

The Proposed Regulations relax the rules proposed in earlier Notices²⁶ and place more reliance on electronic searches. Due diligence procedures vary depending on whether an account is held by an individual or an entity, whether it is a preexisting or new account,²⁷ whether it is an "offshore obligation." Due diligence procedures also vary with the balance in the account.

²⁵ The ownership interest is based on stock (by vote or value) in the case of corporations; profits or capital interests in the case of partnerships; ownership in the case of grantor trusts; and beneficial interest in the case of any other trusts.

²⁶ Notices 2010-60, 2010-37 IRB 329, and 2011-34 contained provisional guidance for the identification of US accounts.

²⁷ A preexisting account is an account opened before the FFI Agreement went into effect, which is June 30, 2013 for Participating FFIs entering into an FFI Agreement between January 1 and June 30, 2013, and the date the FFI Agreement is signed for all other Participating FFIs.

a. Due Diligence by Participating FFIs

More specifically, the following procedures generally apply with respect to “offshore obligations.”²⁸

- **Preexisting Entity Accounts:** A review of preexisting *entity* offshore accounts with balances not in excess of \$250,000 is not required until the balance exceeds \$1 million. For accounts in excess of \$1 million, Participating FFIs must obtain information regarding all substantial US owners of “passive NFFEs” (i.e., a passive investment entity that is not an FFI, e.g., an NFFE with substantial passive investments in real property) or certification from the passive NFFE that it does not have any substantial US owners. FFIs generally are able to rely on information collected under AML/KYC due diligence processes to identify such substantial US owners and, as the preamble of the Proposed Regulations suggests, to identify whether an NFFE is excepted from providing information of its substantial US owners. Entity accounts held by certain “*prima facie* FFIs” must be documented within one year of the effective date of the FFI Agreement.²⁹
- **New Entity Accounts:** Appropriate forms of documentation are specified by category of entity for entity accounts.
- **Preexisting Individual Accounts:** Generally, accounts with a balance up to \$1 million require only an electronic search for US indicia, as described below, which must be completed within two years from the effective date of the FFI Agreement. No search is required for accounts with a balance of no more than \$50,000.³⁰ For accounts with a balance over \$1 million, an enhanced inquiry by relationship managers is required within one year of the effective date of the FFI Agreement.³¹ Moreover, if no US indicia were found through the electronic search, the Participating FFI must review the current master files and other documents that were obtained within the last five years.
- **New Individual Accounts:** A Participating FFI may generally rely on documentary evidence establishing whether an individual is a US person or a non-US person. Such evidence includes most types of government issued identification supporting the status as a US or non-US person. Additional information is required for accounts with US indicia that claim status as non-US accounts.
- **Diligence Regarding Participating FFIs and Registered Deemed-Compliant FFIs:** Participating FFIs must confirm the status of accounts purportedly held by Participating FFIs or registered deemed-compliant FFIs, because a Participating FFI must treat an FFI as no longer qualifying if it is removed from the list of Participating FFIs or registered deemed-compliant FFIs on the earlier of the date on which the Participating FFI discovers that the FFI has been removed or one year from the date of removal. Therefore, such a confirmation procedure must be conducted at least annually.

A Participating FFI that does not obtain the required information may rely on presumption rules in determining its FATCA withholding obligations. Passthru payments to a presumed foreign entity under these rules must be treated as made to a Non-Participating FFI.

²⁸ Offshore obligations are accounts, instruments and contracts maintained and executed at an office or branch of a withholding agent, including a Participating FFI, at a location outside of the United States or in any location in a possession of the United States.

²⁹ See note 21 above.

³⁰ This threshold is increased to \$250,000 for cash value insurance or annuity contracts.

³¹ This replaces the due diligence provisions for “private banking accounts” of the Notices, which would have applied to accounts with balances over \$500,000.

US indicia of an account are present if the information that the Participating FFI is required to review includes (1) identification of the account holder as a US citizen or resident; (2) an account holder having a US place of birth, a US resident address, a US mailing address (including a US post office box) or a US telephone number; (3) standing instructions to transfer funds to an account maintained in the United States; (4) a power of attorney or signatory authority granted to a person with a US address; or (5) an “in-care-of” address or “hold mail” address that is the sole address identified by the Participating FFI for the holder.³²

The preamble to the Proposed Regulations clarifies that a Participating FFI would not be held strictly liable for a failure to identify US accounts if it complies with its FFI Agreement. However, a responsible officer of the FFI must certify that the Participating FFI (1) is conducting due diligence in accordance with the FFI Agreement (including completion of reviews of preexisting accounts within the applicable period) and (2) to his or her knowledge, is not engaged in helping account holders avoid the application of the FATCA rules.

b. Due Diligence by US Withholding Agents

US withholding agents (including US branches of foreign banks that elect to be treated as US persons) generally must obtain new IRS Forms W-8BEN or W-9 (or other withholding certificates) to identify the FATCA-relevant category of an entity. Transitional rules apply to payments made before January 1, 2017 with respect to pre-existing accounts, based on existing information collected by the withholding agent.

In addition, like Participating FFIs, US withholding agents must confirm at least annually an account holder’s status as a Participating FFI or registered deemed-compliant FFI described above.

III. Joint Statement Concerning Intended Agreements with Certain Countries

On February 8, 2012, Treasury issued a joint statement with the governments of Germany, the United Kingdom, France, Italy and Spain announcing their intention to enter into bilateral agreements requiring reciprocal financial reporting. The Irish tax authority recently also indicated that it was in such discussions with Treasury. Under this framework, the United States would enter into an agreement with each of these countries (a “FATCA partner”), and each FATCA partner would agree to collect information required under FATCA from FFIs in its jurisdiction and to transmit this information to the United States. The United States would commit to reciprocal collection and reporting of information to the FATCA partner with respect to US accounts of residents of the FATCA partner.

In return, an FFI organized in a FATCA partner would be able to become a registered deemed-compliant FFI (unless it is otherwise an excepted FFI) and, by reporting the relevant information to the FATCA partner, would no longer be required to enter into an FFI Agreement to avoid FATCA withholding and to report US account information to the IRS.

An FFI organized in a FATCA partner would also not be required to withhold on passthru payments to recalcitrant account holders or to other FFIs organized in any FATCA partner, or to close accounts of recalcitrant account holders.

³² The presumption of being a US person on account of these indicia is rebuttable, but may in some cases be difficult to overcome. In particular, a Participating FFI is permitted to treat an account holder for whom it has information of a birth place in the United States as a non-US person only if the account holder furnishes (1) an IRS Form W-8BEN; (2) a government-issued identification evidencing citizenship in a country other than the United States; and (3) a copy of the holder’s Certificate of Loss of Nationality of the United States (or a reasonable explanation of his or her renunciation of US citizenship or why he or she did not obtain US citizenship at birth).

The purposes of this alternative approach are to avoid legal restrictions under, e.g., data privacy laws, that otherwise would make FATCA compliance illegal for financial institutions in various countries, and further, to attempt to reduce somewhat the burdens on financial institutions, while achieving the mutual objective of the countries to combat international tax evasion.

This joint statement has attracted enormous interest among other countries since its release. Many countries, including all EU countries, are reportedly in discussions or planning discussions with the Treasury Department concerning such bilateral agreements. A serious consequence is that certain FFIs are hesitant to incur substantial expenditures to build out FATCA systems until clarity concerning the requirements under the anticipated bilateral agreements is available.

IV. Time Line for the Implementation of FATCA

The Proposed Regulations set forth the following proposed schedule for the implementation of FATCA:

2012

- **December 31, 2012.** This is the last day for the issue date of a “grandfathered obligation.” Payments on obligations with an issue date of January 1, 2013 or later will be subject to FATCA withholding.

2013

- **January 1, 2013.** The IRS begins accepting FFI applications.
- **June 30, 2013.** FFIs must sign an FFI Agreement by this date to ensure treatment as Participating FFIs beginning on January 1, 2014.

2014

- **January 1, 2014.** FATCA withholding on US source FDAP begins.
- **June 30, 2014.** FFIs that entered into FFI Agreements effective June 30, 2013 must identify and obtain documentation of relationship managers and document accounts held by prima facie FFIs.
- **September 30, 2014.** FATCA reports for calendar year 2013 are due and must include each US account holder’s name, taxpayer identification number and account balance.

2015

- **January 1, 2015.** FATCA withholding on gross proceeds begins.
- **January 30, 2015.** Deadline for responsible officer certification that due diligence on all accounts has been completed.

2016

- **January 1, 2016.** The transition period for expanded affiliated groups expires. After this date, in order for any member of an expanded affiliated to be a Participating FFI, all members of the expanded affiliate group must be participating FFIs.
- **March 31, 2016.** FATCA reports are due and must also include income associated with US accounts (applicable with respect to 2015 and later years).

2017

- **January 1, 2017.** Withholding on foreign passthru payments may begin on this date or later, subject to further rulemaking.
- **March 31, 2017.** FATCA reports are due and must include full information, including gross proceeds reporting (applicable with respect to 2016 and later years).

* * *

SHEARMAN & STERLING^{LLP}

This overview is based on FATCA, the Proposed Regulations thereunder and the Joint Statement. The Proposed Regulations are subject to change, and final regulations under FATCA, as well as the regimes implementing the Joint Statement, likely will impose different and possibly additional requirements on FFIs or NFFEs under FATCA. In addition, the form of the FFI Agreement, and of any corresponding agreement pursuant to the Joint Statement, has not yet been published by the IRS. Foreign financial entities in particular should therefore continue to monitor FATCA developments for additional guidance that the IRS will issue.

Circular 230 Disclosure

Any tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of avoiding tax penalties and is not intended to be used or referred to in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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