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International Tax

United States Tax Alert

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Foreign Account Tax Compliance: Initial Guidance Issued on Chapter 4 (Code §§1471-1474)

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On August 27, 2010, Treasury and the Internal Revenue Service (IRS) issued initial, and lengthy, guidance under new §§1471-1474 of the Internal Revenue Code ("chapter 4").[1] Chapter 4 is designed to prevent U.S. persons from evading U.S. tax by holding income-producing assets through accounts at foreign financial institutions ("FFIs") or through other foreign entities (non-financial foreign entities, or "NFFEs").[2] The law does so by imposing tough new withholding tax requirements on "withholdable payments" to foreign entities, which generally take effect January 1, 2013, subject to exceptions for FFIs that enter into agreements ("FFI Agreements") with the IRS to identify and report on their "U.S. accounts" and for NFFEs that provide information about their "substantial U.S. owners."

The new guidance takes the form of Notice 2010-60, which explains in detail the terms that will be imposed by FFI Agreements and the types of foreign entities that can receive payments without chapter 4 withholding. The notice also states that, in future guidance, the Treasury and the IRS intend to publish a draft FFI Agreement and draft information reporting and certification forms. Importantly, in addition to guiding foreign entities through the process of deciding whether or not they must enter FFI Agreements in order to avoid chapter 4 withholding, and understanding what such an agreement entails, the notice provides guidance for *U.S.* financial institutions ("USFIs") to determine whether or not they are free to refrain from withholding on

[1] Unless expressly stated otherwise in this document, all references to the Code are to the Internal Revenue Code of 1986 and the regulations thereunder as amended.
[2] Chapter 4 was added to the Code by §501(a) of the Hiring Incentives to Restore Employment Act of 2010 ("HIRE Act"), Pub. L. No. 111-147, enacted March 18, 2010. Section 501(a) is a revised version of provisions that originally appeared in a bill entitled the "Foreign Account Tax Compliance Act of 2009," H.R. 3933, S. 1934 (introduced on October 27, 2009), and is sometimes referred to as "FATCA."

"withholdable payments."[3]

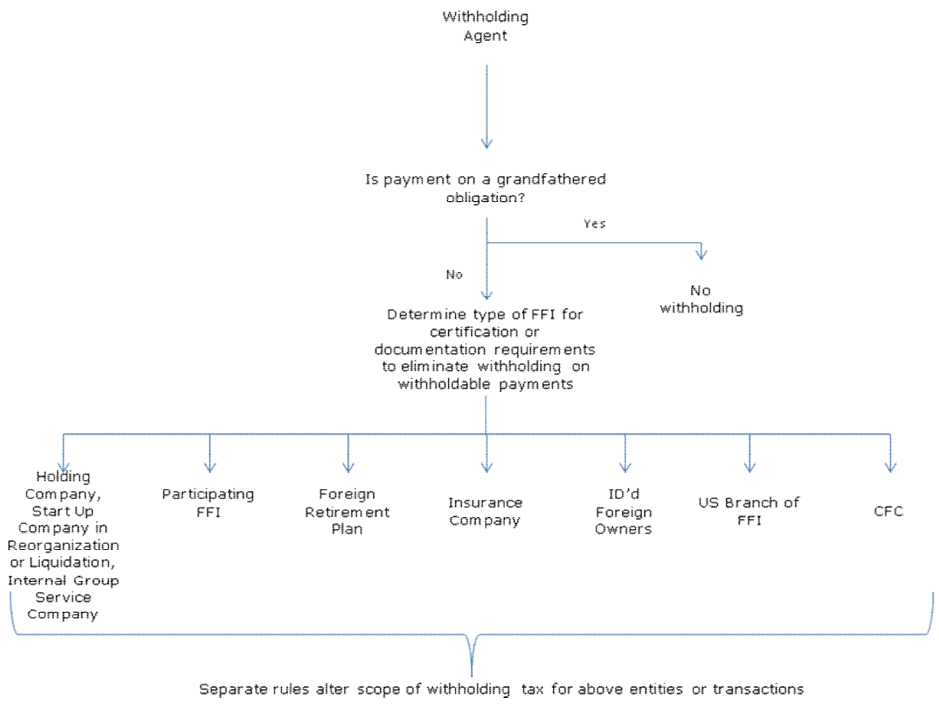
This alert provides a brief summary of some of the notice's highlights. It is not a comprehensive discussion of the notice's contents. We plan to publish a more detailed analysis in the near future.

A. Overview

The notice deals with limited aspects of chapter 4: generally, how a withholding agent will know whether a withholdable payment that it makes is eligible for the "grandfather" rule that applies to certain payments on obligations outstanding on March 18, 2012; and, if not, whether a payment to an FFI is or can be exempt from withholding under §1471(a) (and in some cases, whether payments are exempt from §1472(a)).

In particular, the notice deals extensively with the way in which an FFI will meet the requirements of §1471(b) via an FFI Agreement with the IRS, thereby being a "participating FFI" eligible for exemption from §1471(a) withholding. It also addresses whether an FFI, even if not a participating FFI, is still eligible to be entirely excluded from the class of recipients subject to withholding under §1471(a). It deals with this question in the context of holding companies, certain group internal financial service companies, start-ups and companies in the process of liquidating or reorganizing, insurance companies, retirement plans, controlled foreign corporations (CFCs), entities with identified owners and FFIs with U.S. branches. The diagram below provides a broad overview of the issues addressed by the notice:

[3] The term "withholdable payment" is generally defined in §1473(1)(A) to include: (i) any payment of interest (including any original issue discount), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, or periodical gains, profits, and income, if such income 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.



B. FFIs and NFFEs

Withholdable payments to FFIs are subject to §1471(a) withholding, unless the FFI is: a "participating FFI" (one that has entered into a §1471(b)(1) FFI Agreement described in the notice); a "deemed-compliant FFI" (FFIs referred to in §1471(b)(2) that are eligible, even without entering into an FFI Agreement, for exemption from §1471 withholding); or described in §1471(f) (and thus exempt from withholding under §1471(a)), which describes governmental and international organizations and foreign central banks of issue. Treasury may also identify other classes of persons posing a low risk of tax evasion, making them eligible to be treated as described in §1471(f); the notice identifies such a class.

1. FI definition in general

Section 1471(d)(5) defines "financial institution" (hereinafter, "FI") by reference to three alternative activities: (A) deposit-taking in a banking or similar business; (B) the holding of financial assets for the account of others; and (C) engaging primarily in the business of investing, reinvesting, or trading in financial assets including securities, partnership interests, and commodities, and derivative interests therein.

The notice states that category (A) includes savings banks, commercial banks, S&Ls, thrifts, credit unions, building societies and other cooperative institutions. The notice states that category (B) includes broker-dealers, clearing organizations, trust companies, custodial banks and entities acting as custodians with respect to the assets of

employee benefit plans. With respect to both categories (A) and (B), the notice states that the fact that an entity is subject to the banking and credit laws or broker-dealer regulations of any country or political subdivision is relevant to but not necessarily determinative of whether the entity fits in the category.

The notice states that category (C) includes, but is not limited to, mutual funds (or their foreign equivalent), funds of funds (and other similar investments), exchange-traded funds, hedge funds, private equity and venture capital funds, other managed funds, commodity pools and "other investment vehicles." Of particular interest is a statement in the notice that future guidance is expected to provide guidelines for determining what types of activity constitute investing, reinvesting or trading and when an entity is primarily engaged in such activity.

2. Excluded FIs

The notice states that Treasury and the IRS intend to issue regulations providing that a foreign entity that otherwise satisfies the definition of an FI solely because it is primarily engaged in investing, reinvesting or trading in securities will not be treated as an FI if it falls within one of four classes, and also that payments beneficially owned by such entity will be exempt from withholding under §1472(a). The four categories are:

- Certain holding companies – Holding companies for subsidiaries primarily engaged in a trade or business other than an FI business. This exception will not apply to an entity acting as an investment fund, such as a private equity, venture capital or leveraged buyout fund, or vehicle intended to acquire or fund the start-up of companies and then hold those companies for investment purposes for a limited period of time.

- Start-up companies – 24-month exclusion after the organization of a foreign entity investing into assets with intent to operate a non-FI business. The 24-month exclusion is not available to a venture fund or other investment fund that invests in start-up entities.

- Non-financial entities in liquidation or emerging from reorganization or bankruptcy – Applicable to entities that were not FIs before the liquidation or reorganization, and whose continued or recommenced operations (if any) are to be non-FI businesses.

- Hedging and financial centers of a non-financial group – Applicable to a member of an expanded affiliated group if the member is primarily engaged in financing or hedging transactions with or for its affiliates that are not FFIs and renders such services only to affiliates, provided that the group engages in a non-FI business.

3. Insurance companies

Treasury and the IRS plan to issue regulations treating entities whose

business consists solely of issuing insurance or reinsurance contracts without cash value as non-FIs for chapter 4 purposes. These would include, for example, most property and casualty insurance or reinsurance contracts or term life insurance contracts. No comparable exemption is provided for issuers of life insurance or annuity contracts with an investment component, although comments on the treatment and definition of such contracts are requested.

4. Entities with certain identified owners

The notice provides that FFIs with a small number of direct or indirect account holders, all of whom are either individuals (e.g. a family trust settled by one person for the sole benefit of his or her children) or "excepted NFFEs" (NFFEs not subject to §1472(a) because they are listed in §1472(c)[4]) will be "deemed-compliant FFIs" if the withholding agent:

(i) Specifically identifies each individual, "specified U.S. person,"[5] or excepted NFFE that has an interest in such entity, either directly or through ownership in one or more other entities;

(ii) Obtains from each such person the documentation that the withholding agent would be required to obtain from such person under the notice if such person were a new account holder or direct payee of the withholding agent; and

(iii) Reports to the IRS any specified U.S. person identified as a direct or indirect interest holder in the entity.

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[4] Excepted NFFEs include: (A) corporations whose stock is regularly traded on an established securities market; (B) corporations which are members of the same expanded affiliated group as a regularly traded corporation described in (A); (C) entities organized in U.S. territories; (D) any foreign government, any political subdivision or any wholly owned agency or instrumentality of any of the foregoing; (E) any international organization or wholly owned agency or instrumentality thereof; (F) any foreign central bank of issue; or (G) any other class of person identified by the Secretary for this purpose.

[5] Section 1473(3) generally defines the term "specified U.S. person" as any U.S. person, other than –

(A) Any corporation the stock of which is regularly traded on an established securities market;
(B) Any corporation which is a member of the same expanded affiliated group (as defined in §1471(e)(2) without regard to the last sentence thereof) as a corporation the stock of which is regularly traded on an established securities market;
(C) Any organization exempt from taxation under §501(a) or an individual retirement plan;
(D) The United States or any wholly owned agency or instrumentality thereof;
(E) Any State, the District of Columbia, any possession of the United States, any political subdivision of any of the foregoing, or any wholly owned agency or instrumentality of any one or more of the foregoing;
(F) Any bank (as defined in §581);
(G) Any real estate investment trust (as defined in §856);
(H) Any regulated investment company (as defined in §851);
(I) Any common trust fund (as defined in §584(a)); and
(J) Any trust which—
  (i) is exempt from tax under §664(c), or
  (ii) is described in §4947(a)(1).

Note that, as an FFI, such an entity generally would also be exempt from withholding under §1472(a).

5. Certain Foreign Retirement Plans

Treasury and the IRS intend to issued guidance that certain foreign retirement plans will constitute a class of persons posing a low risk of tax evasion pursuant to §1471(f)(4), and thus exempt from §1471(a). In order to qualify, the plan must:

(i) Qualify as a retirement plan under the law of the country where the plan was established;

(ii) Be sponsored by a foreign employer; and

(iii) Not allow U.S. participants and beneficiaries other than employees who worked for the foreign employer in the country where the plan was established during the time the benefits accrued.

We would expect that such a plan generally would also meet the definition of an FFI, and thus be exempt from withholding under §1472(a).

6. U.S. Branches of FFIs

The notice states that FFIs receiving withholdable payments solely through their U.S. branches will *not* be exempt from the requirement to enter into an FFI agreement in order to avoid §1471(a) withholding. Note that payments received by a U.S. branch *for its own account* may be effectively connected with the conduct of a trade or business in the United States ("ECI"), and thus excluded from the definition of "withholdable payment" pursuant to the "ECI exclusion" of §1473(1)(B). Treasury and the IRS intend to issue regulations regarding the application of the ECI exclusion by withholding agents making payments to U.S. branches of FFIs. The notice states that Treasury and the IRS do not intend that the regulations will incorporate the type of special presumption included for chapter 3 withholding purposes in Treas. Reg. §1.1441-4(a)(2)(ii) for payments made to certain U.S. branches of regulated banks and insurance companies. Comments are requested as to other possible rules or methods that withholding agents could use to determine the application of the ECI exclusion.

When a U.S. branch of an FFI receives a withholdable payment as an intermediary, Treasury and the IRS are considering permitting the U.S. branch to document its account holders for chapter 4 withholding purposes under the requirements to be imposed on USFIs, discussed below. Treasury and the IRS anticipate that regulations will include rules coordinating the chapter 4 reporting required of FFIs with U.S. branches with other U.S. tax reporting obligations, so as to avoid duplicative reporting with respect to accounts maintained by the U.S. branch of the FFI.

7. Controlled Foreign Corporations

The notice indicates that Treasury and the IRS have decided that FFIs that are also CFCs will not be treated as "deemed-compliant FFIs" (meaning that they must become "participating FFIs" in order to avoid being withheld upon under chapter 4). The notice provides a rationale for this decision, which discusses the ways in which the documentation and reporting requirements to which CFCs are currently subject are less stringent than those that apply to FFIs under chapter 4. Treasury and the IRS do anticipate coordinating the chapter 4 reporting imposed on CFCs with other U.S. tax reporting obligations, with the objective of avoiding duplicative reporting.

8. Foreign charitable organizations, etc.

The notice requests comments on whether there are other specific classes of foreign entities that that should be: (i) excluded from the definition of FFI; (ii) "deemed-compliant FFIs" (deemed to meet the requirements of §1471(b) pursuant to §1471(b)(2)); or (iii) identified as posing a low risk of tax evasion pursuant to §1471(f). The notice particularly mentions foreign charitable organizations as a candidate for comments.

C. Participating FFIs

In order to avoid withholding under §1471 by entering into an FFI Agreement, and thereby becoming a "participating FFI," the FFI must agree to obtain, verify, and report certain information about its account holders. The notice provides a detailed explanation of what is required to comply with such an agreement. The participating FFI must identify and report U.S. accounts. In the case of accounts held by entities, rather than individuals, this means that the FFI must sort through and determine whether the accounts are to be treated as (1) U.S. accounts, (2) accounts of participating FFIs, (3) accounts of deemed-compliant FFIs, (4) accounts of nonparticipating FFIs, (5) accounts of entities described in §1471(f), (6) accounts of recalcitrant account holders, (7) accounts of excepted NFFEs, (8) accounts of other NFFEs, or (9) other accounts. (While this is necessary to satisfy the FFI Agreement, it is also necessary for any withholding agent (e.g. a USFI) to make similar determinations with respect to the recipients of withholdable payments.) (See chart.)

	Required Determination for Compliance on Entity-Held Accounts								
	U.S. Person / U.S. Accounts[1]	**Participating FFIs**	**Deemed-Compliant FFIs**	**Non-Participating FFIs**	**Entities Described in §1471(f)**	**Excepted NFFEs**	**Recalcitrant Account Holders**	**Other NFFEs**	**Other Accounts**
USFI	X	X	X	X	X	X		X	
PFFI[2]	X	X	X	X	X	X	X	X	X
Notes: (1) U.S. person - USFI; U.S. Accounts – Participating FFI; (2) For USFI, the required determination is made on the individual or entity itself. Alternatively, in the case of PFFI the required determination is made on the account of the relevant entity.									

In so doing, FFIs will be allowed to rely on forms W-9 and W-8BEN for purposes of chapter 4. In order to ease this complex identification process by withholding agents and participating FFIs, the notice

announces that the IRS will issue EINs to participating FFIs (so-called "FFI EINs"). Until withholding agents are able to verify the status of FFIs with the IRS through this mechanism, withholding agents and participating FFIs will be permitted to rely on certifications provided by FFIs as to their status as participating FFIs, unless the withholding agent or participating FFI knows or has reason to know that the certification provided is incorrect. Treasury and the IRS contemplate requiring USFIs to report information regarding the identity of any entity that provides documentation indicating that it is a participating FFI, but that does not provide a valid FFI EIN.

The notice also provides detailed guidance regarding the due diligence required to obtain information on each account maintained by the FFI to determine whether they are U.S. or foreign accounts and to report certain information (including average account balances) with respect to the U.S. accounts. The guidance contains separate rules for financial accounts held by individuals and financial accounts held by entities. Separate rules are also provided for each with respect to "pre-existing accounts" and "new accounts." In the case of existing accounts, the notice provides certain presumptions, and allows the identification of such accounts based on electronically searchable information in the FFI's files. In the case of new accounts, the determination generally must be based upon *all* information collected by the FFI, which in the case of entity accounts clearly means regardless of whether such information is available in electronically searchable files. In the case of accounts held by individuals, the FFI must re-verify within two years after the FFI Agreement entered into effect whether certain accounts remain properly treated as *other than* U.S. accounts; and the standards for existing and new individual accounts merge into a single standard beginning five years after the FFI Agreement entered into effect.

Treasury and the IRS intend to issue regulations providing that, in the case of a participating FFI that maintains an account of another participating FFI, only the participating FFI that has the more direct relationship with the investor or customer will be required to report the information required under §1471(c). The notice announces that the IRS is developing a new form for reporting qualitative and account value information and that the form will be required to be filed electronically. Amounts will be reportable in U.S. dollars and future guidance will provide currency translation conventions.

D. Payments on Grandfathered Obligations

Chapter 4 is generally effective for payments made after 2012, but it does not require any amount to be deducted or withheld from any payment under any "obligation" outstanding on March 18, *2012,* or from the gross proceeds from any disposition of such an obligation.[6] The notice states that Treasury and the IRS intend to issue regulations stating that the term "obligation" for this purpose means "any legal agreement that produces or could produce withholdable payments,"

[6] See HIRE Act §501(d)(2).

except that it does not include any instrument treated as equity for U.S. tax purposes or any legal agreement that lacks a definitive expiration or term (e.g. savings deposits or demand deposits). In addition, a legal agreement that produces withholdable payments excludes brokerage, custodial and similar agreements to hold financial assets for the account of others and to make and receive payments of income and other amounts with respect to such assets.

Material modifications of obligations will result in the obligation being treated as newly issued. In the case of obligations that are indebtedness for U.S. tax purposes, a material modification means any "significant modification" as defined in Treas. Reg. §1.1001-3. Outside the indebtedness context, "material modification" will be determined based on all relevant facts and circumstances.

E. Miscellaneous

The notice states that Treasury and the IRS contemplate permitting withholding agents other than USFIs to rely on a foreign entity's certification as to its classification for chapter 4 purposes, absent reason to know that such certification is unreliable or incorrect. These requirements would also apply with respect to withholdable payments made by FFIs and USFIs to NFFEs that are not holders of financial accounts maintained by the FI. Treasury and the IRS also anticipate providing an exception to §1472 withholding for a payment made to an NFFE engaged in an active trade or business by a withholding agent other than an FI.

The notice also indicates that Treasury and the IRS are considering ways to minimize the burden on participating FFIs, such as whether to exempt a participating FFI from the §1471(b)(1)(D)(i) obligation to withhold on "passthru payments" to individual "recalcitrant account holders" where the IRS can obtain information about the identities of the account holders through an information exchange request to a foreign jurisdiction.

The notice states that proposed regulations will be issued with sufficient time for affected persons to implement the systems and processes necessary to fully comply with the new withholding, documentation and reporting obligations imposed by chapter 4 (which obligations will demand that institutions and others exercise due diligence and collect information that is not necessarily required today). The notice requests comments (and identifies many specific questions on which comments are requested) by November 1, 2010.

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