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Foreign Account Tax Compliance Provisions Have Far-Reaching Effect

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This paper addresses certain groundbreaking provisions in respect of U.S. withholding tax and information reporting that were enacted as part of the Hiring Incentives to Restore Employment (HIRE) Act (the "HIRE Act"), which was signed into law on March 18, 2010.[1] These provisions are commonly referred to as the Foreign Account Tax Compliance Act ("FATCA") provisions. This paper analyzes certain key aspects of the FATCA provisions.

Section 501 of the HIRE Act adds new Code[2] sections 1471-74, which impose sweeping new information gathering and reporting rules for foreign financial and non-financial entities, backed up by a new withholding tax. The intended targets are those U.S. individuals who otherwise would attempt to avoid U.S. tax on income received through foreign intermediaries or foreign beneficial owner entities. These provisions dramatically bolster the Government's arsenal to impede the ability of U.S. persons to hide income and assets offshore, but do so largely on the backs of foreign financial institutions. Virtually every foreign financial or investment entity (as well as virtually every non-public foreign operating company) that directly or indirectly, including through another entity, participates in US investments will be affected.

Section 502 of the HIRE Act repeals the exception to the registration requirement for foreign targeted bearer bonds, effectively eliminating the ability of U.S. issuers to issue such bonds.

Section 541 of the HIRE Act adds new Code section 871(l), a new U.S. source rule for dividend equivalent payments under certain U.S. equity-based swaps and other notional principal contracts, effectively imposing U.S. withholding tax on such payments.

I. Expanded Information Reporting and New Withholding Provisions (Section 501 of the Act and New Sections 1471-74 of the Code)

A. <u>Background</u>

The U.S. rules for nonresident withholding are reasonably well designed to ensure that foreign persons holding U.S. stocks and securities through foreign financial institutions ("FFIs"),

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or otherwise, pay the proper amount of U.S. tax on the income arising from such U.S. investments. In such context, reliance on third party reporting and withholding always has been the mainstay of compliance, in lieu of an independent filing obligation of the recipient of the income. Similarly, third party reporting and "backup" withholding have long been applicable to domestic payors of investment income (and certain non-US payors of U.S. source amounts and gross proceeds) to U.S. persons (other than exempted persons) who fail to provide certain taxpayer identifying information.

For example, a U.S. issuer or agent paying U.S.-source dividend income to a FFI generally must withhold at a 30% rate under Code sections 1441-42, except to the extent that the FFI is (1) a qualified intermediary ("QI")[3] that assumes responsibility for withholding on the dividend at a 30% rate or a reduced withholding rate under a U.S. income tax treaty ("reduced treaty rate");[4] (2) a QI that does not assume such withholding responsibility but, as required, determines the portion of the dividend that qualifies for a reduced treaty rate and instructs the payor accordingly;[5] (3) a nonqualified intermediary that (a) indicates the portion of the dividend allocable to any beneficial owner that is entitled to a reduced treaty rate, and (b) provides documentation from such beneficial owner supporting the claim of treaty benefits; or (4) the beneficial owner and provides documentation of its entitlement to a reduced treaty rate. The 30% nonresident withholding tax does not apply to the extent that the FFI provides the payor with an appropriate certification or documentation of the beneficial owner's status as a U.S. person; but backup withholding will then be imposed (by either the payor or the FFI, depending on the circumstances) if the beneficial owner (1) is not an "exempt person" (such as a corporation) to which the backup withholding rules do not apply, and (2) has not provided its TIN (and satisfied other applicable requirements).[6] Similar rules govern the payment of U.S. source interest, which, however, generally qualify for 0% withholding under the portfolio interest exemption to the extent that the payment can be associated with documentation evidencing a foreign beneficial owner.

Third party reporting rules generally do not apply to income earned by U.S. persons through FFIs, or income earned by U.S. persons through foreign investment vehicles.[7] Moreover, most interest earned though accounts at FFIs qualifies for the "portfolio interest exemption" from U.S. withholding tax. Capital gains earned by foreign persons generally are not considered subject to U.S. withholding tax. Therefore, U.S. persons have largely been able to maintain accounts at FFIs, invest in U.S. stocks and securities, and avoid detection by the IRS at the sole cost of a dividend withholding tax. As reported in the press in recent years, some thousands of U.S. individuals have avoided their income tax obligations through the use of offshore accounts. Self-reporting alone has proved inadequate.

In order to improve compliance in this area, Congress and Treasury determined that extending third party reporting was critical. Hence, the FATCA provisions harness the private sector--specifically foreign financial institutions—to bear the burden by diligencing their investors and disclosing information to the IRS about their U.S. account holders and U.S. owners. As explained in detail below, new Code sections 1471-74 use the threat of U.S. withholding tax as a "club" to compel FFIs and other foreign entities to comply with extensive reporting requirements. Thus, although the targets of the concern are U.S. persons, the targets of the compliance effort are foreign entities.

Jurisdictionally, Congress's only leverage is U.S. source payments, as it can only impose tax on such payments. These limits are stretched, perhaps beyond the breaking point, by sections 1471-74, as discussed below with respect to so-called passthru payments. Even so, it can easily be anticipated that determined U.S. persons wishing to evade U.S. tax will find ample ways to do so. For example, many FFIs, especially smaller ones, will simply opt out of the new rules by declining to invest directly or indirectly (including through another FFI) in U.S. securities or deposits; and such nonparticipating FFIs will then be free to accept deposits without diligencing or reporting a depositor's U.S. status. Hence, there is a real possibility that these provisions will be an exercise in futility.

It should be kept in mind that, although sections 1471-74 provide for withholding tax, the purpose of the provisions is not to collect any tax. The purpose is to improve compliance by having in place a system to obtain third party reporting concerning foreign financial accounts of U.S. persons, including those owning investments through closely held foreign entities, and information on payments (including foreign source payments) to such persons or entities. That said, the revenue estimate projected tax collections of $8.7 billion from the provision and the provision was included in the HIRE Act as a partial "offset" to the expenditures under that Act.

B. Overview of FATCA Reporting and Withholding Regime

1. Due Diligence and Reporting Requirements

As explained in more detail at part C below, a FFI will be required to enter into agreements with the IRS requiring it, among other things, to determine which of its accounts are U.S. accounts, to report certain information to the IRS regarding such accounts and to withhold on (or elect to be withheld on with respect to) payments that are U.S. source (or considered indirectly to be from U.S. sources) made to accountholders and investors in the FFI's non-publicly traded equity and debt interests who fail to provide identifying information.

Foreign entities that are not FFIs ("non-financial foreign entities" or "NFFEs") will not be required to enter into agreements with the IRS, and will "only" be required either to certify that they have no 10% or greater U.S. owners or to disclose the identities of any such owners to the IRS; and failing that, to be subject to withholding of U.S. tax on amounts that are U.S. source or considered indirectly to be from U.S. sources.

2. Withholding on Withholdable Payments

As explained in more detail in part D below, Code sections 1471-74 will dramatically change the nonresident withholding tax landscape by creating a new, side-by-side regime that, for non-compliant foreign persons, potentially would impose a 30% gross withholding tax ("FATCA withholding") on payments and gross proceeds (or amounts indirectly attributable thereto) from the sale of any equity or debt instrument issued by a U.S. issuer. Subject to grandfathering of "obligations" issued prior to March 19, 2012, the withholding tax can be avoided with respect to payments after December 31, 2012, only if the foreign entity and its U.S. account or interest holders comply with the reporting requirements referred to above and described below.[8]

The new regime will be buckled onto the existing withholding tax regimes. To the extent FATCA withholding is not required, the "normal" withholding tax rules will continue to apply. To the extent FATCA withholding is required (e.g., due to noncompliance with reporting obligations), duplicative withholding will not be required under the normal withholding tax rules,[9] but in order to obtain a refund (where permitted) the normal regime will be applicable.

3. Decisions for FFIs

An FFI has, basically three basic choices in confronting the new regime with respect to payments on and after the January 1, 2013 effective date. First, it could continue to invest as currently, enter into an agreement with the IRS when the form agreement is available and perform its diligence, reporting and withholding obligations thereunder. Larger institutions may be inclined to do this and obviously will want to be part of the dialogue and process with Treasury and the IRS of implementing the regime in a sensible manner.

Second, it could opt to have no U.S. customers whatsoever and enter into a simplified agreement with the IRS.

Third, it could cease holding investments that generate U.S. source income. This approach likely would require fairly drastic changes in investment strategy, as not only must direct investments, including through financial intermediaries, be avoided, but also investments or deposits in any FFI that itself has U.S. source income (directly or through another FFI).

C. <u>FATCA Diligence and Reporting Provisions</u>

The information reporting requirements that will have to be met by January 1, 2013 to switch off FATCA withholding are much more burdensome for FFIs, as opposed to NFFEs. Below we describe the requirements for FFIs and then for NFFEs.

1. Foreign Financial Institutions - FFIs

a. Definition of FFI

Since FFIs are subject to more burdensome requirements than NFFEs, a critical question for a foreign entity is whether it will "qualify" as an FFI. Section 1471 defines FFI extremely broadly.

Pursuant to section 1471(d)(4) and (5), an FFI generally includes any bank or similar deposit-taking institution, any entity engaged in the business of holding financial assets for the account of others and any entity engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities or interests or derivatives therein, provided it is not a U.S. person or organized under the laws of any U.S. possession. Such entities include not only financial institutions in the narrow sense (e.g., banks) but also, for example, securitization vehicles, private equity funds, hedge funds, and family investment vehicles.

b. The 1471(b) Agreement

Under section 1471(a) and (e), payments to an FFI, whether in an intermediary capacity or as beneficial owner, will be exempt from FATCA withholding if the payee FFI enters into an agreement with the IRS satisfying the requirements of section 1471(b) (a "section 1471(b) agreement") with respect to accounts maintained by the FFI (and its 50% affiliates[10] that have not separately entered into such agreements) to identify U.S. accounts in accordance with verification and due diligence procedures to be specified in regulations, to make annual reports of such U.S. accounts to the Treasury in accordance with Treasury regulations and to comply with requests by the Secretary for additional information. In addition, the FFI will have to agree to close any U.S. account if a foreign law prevents information reporting unless waiver of such foreign law can be obtained. Treasury will be empowered to terminate a section 1471(b) agreement if it determines that the FFI "is out of compliance with such agreement."

A "United States account" generally includes any "financial account" held by one or more "specified United States persons" or "United States owned foreign entities" (each as defined below). Section 1471(d)(1)(A). However, a United States account generally does not include any depository account owned solely by a natural person if all of the accounts owned by the person at the FFI (and, to the extent provided by the Secretary, 50% affiliates of the FFI) have an aggregate value of $50,000 or less. Section 1471(d)(1)(B). An FFI that wishes to do so may elect for this exception not to apply. A U.S. account also excludes any financial account that is held by an FFI that has entered into its own 1471(b) agreement or is otherwise subject to information reporting requirements that the Secretary determines would make the reporting duplicative. Section 1471(d)(1)(C). Except as otherwise provided by the Secretary, a financial account includes not only any depository and custodial account, but also equity and debt interests *in* the FFI, but *only if* they are not regularly traded on an establishment securities market. Section 1471(d)(1)(B).

A "specified United States person" ("SUSP") is any U.S. person other than a publicly traded corporation (or its 50% affiliates), a bank, a real estate investment trust, a mutual fund (i.e., a regulated investment company), a tax-exempt organization, an individual retirement plan, certain charitable or partially charitable trusts, the United States or its wholly owned agencies or instrumentalities, any State, any U.S. possession or the District of Columbia or any of their political subdivisions or wholly owned agencies, or a common trust fund. Section 1473(3).

A "United States owned foreign entity" ("USOFE") is any foreign entity with one or more "substantial United States owners" ("SUSOs"). Section 1471(d)(3). For this purpose, a SUSP is considered a SUSO: (i) with respect to a foreign corporation or partnership, if such person directly or indirectly owns more than 10% of the equity interests (by vote or value in the case of corporations, and in capital or profits in the case of partnerships); (ii) with respect to a trust if such person (a) is treated as an owner under the grantor trust rules, or (b) to the extent provided by the Secretary, holds, directly or indirectly, more than 10% of the beneficial interests of such trust; and (iii) with respect to an FFI (other than a deposit-taking or custodial institution), if such person directly or indirectly owns *any* interest (regardless of absolute or relative value or voting rights). Section 1473(2). Thus, for example, any foreign hedge fund or family investment vehicle with an owner that is a SUSP is being considered a USOFE, because the 10% threshold for U.S. ownership does not apply.

Subject to an election to be withheld upon under section 1471(b)(3), a section 1471(b) agreement will require the FFI to deduct and withhold 30% from any "passthru payment"[11] that is made to (1) a "recalcitrant account holder" (as defined below), (2) a "nonparticipating FFI," i.e., an FFI that does not enter into a section 1471(b) agreement, and (3) a participating FFI to the extent that such FFI has elected to be withheld upon, rather than to withhold, with respect to the portion of the payment that is allocable to its own account holders that are either recalcitrant account holders or nonparticipating FFIs (collectively, "noncompliant account holders"). Section 1471(b)(1)(D).

A "recalcitrant account holder" is any account holder that (1) fails to comply with reasonable requests for information necessary to determine if the account is a U.S. account, (2) fails to provide the name, address, and TIN of each SUSP and each SUSO of a USOFE, or (3) fails to provide a waiver of any foreign law that would prevent the FFI from fulfilling its FATCA reporting obligations with respect to the account. Section 1471(d)(6).

A participating FFI will be required annually to report, with respect to each U.S. account maintained by it, the account number and the name, address and TIN of each account holder that is a SUSP or, in the case of a USOFE, of each SUSO, the account balance or value, and the gross receipts and gross withdrawals or payments from the account. Section 1471(c)(1). Alternatively, the FFI could elect full IRS Form 1099 reporting with respect to each account holder that is a SUSP or USOFE, treating it as a U.S. citizen for this purpose. Section 1471(c)(2).

Treasury is authorized to deem an FFI to meet the reporting requirements if the FFI: (1) complies with procedures prescribed by the Secretary to ensure that it does not maintain U.S. accounts, and meets such other requirements as the Secretary may prescribe with respect to accounts, if any, of other FFIs maintained by it; or (2) is a member of a class of institutions for which the Secretary has determined that a section 1471(b) agreement is "not necessary to carry out the purposes" of the FATCA regime. Section 1471(b)(2). As noted at part E below, widely held investment vehicles could be a class that benefits from a determination under this provision.

Under section 1471(b)(3), a participating FFI can elect to have a withholding agent (including another participating FFI) withhold on payments made to it rather than itself acting as a withholding agent for the passthru payments it makes. If this election is made, withholding tax would apply with respect to any passthru payment made *to* the electing FFI to the extent the payment is allocable to accounts held by recalcitrant account holders and nonparticipating FFIs.[12] Section 1471(b)(3). The electing FFI will be required to notify the withholding agent of its election and to provide information necessary for the withholding agent to determine the appropriate amount of withholding. Additionally, the electing FFI will have to waive any right under a treaty with respect to an amount deducted and withheld pursuant to the election. To the extent provided by the Secretary, the election may be permitted with respect only to certain classes or types of accounts rather than generally.

2. Non Financial Foreign Entities - NFFEs

Under sections 1471-72, to be exempt from 30% FATCA withholding, an NFFE must either certify to the withholding agent the absence of SUSOs or provides their names, addresses and TINs. The potential withholding sanction is stated separately for payments from FFIs as opposed to payments from other withholding agents. Section 1471(b)(1)(D) requires an FFI to withhold on U.S. source payments and related gross proceeds as well as other so-called "passthru payments" made to, among other entities, noncompliant USOFEs, which can include noncompliant NFFEs. Section 1472 requires any withholding agent to withhold on U.S. source payments and related gross proceeds paid to noncompliant NFFEs. Apparently, it was not considered necessary in this latter case to address passthru payments as the payor would either be the U.S. issuer itself or, if a financial intermediary, a U.S. person.

The withholding agent will be required to report the name, address and TIN of each such SUSO of the NFFE to Treasury. The withholding agent will be required to withhold if it actually knows or has reason to know that the certification or information is incorrect.

Thus, a beneficial owner's status as either an FFI or an NFFE will have dramatically different consequences. An FFI will be subject to an obligation to enter into an agreement imposing the section 1471(b) account reporting obligations (including disclosure of ownership of its non-publicly traded equity or debt) and, failing to do so, will be subject to the sanction of complete nonrefundability of FATCA withholding, unless an income tax treaty applied. An NFFE, by contrast, will "only" be required to obtain and provide information concerning its SUSOs.

D. FATCA Withholding Provisions

1. *Withholding on Withholdable Payments*

Sections 1471 generally will require 30% withholding on "withholdable payments" made after December 31, 2012, to an FFI that does not enter into a section 1471(b) agreement with the IRS dealing with obligations to perform due diligence, information reporting, withholding and verification, and an obliging the participating FFI to withhold at 30% on withholdable payments and other "passthru payments" made after that date to either a noncompliant FFI or to a "recalcitrant account holder." Section 1472 generally will require 30% withholding on withholdable payments made after December 31, 2012 to a noncompliant NFFE. These provisions will not apply to any "obligation" outstanding on March 18, 2012 (the date that is two years after the date of enactment) or to the gross proceeds from any disposition of such an obligation. Section 1474(d)(2).

Section 1473(1) generally defines a "withholdable payment" to include all (i) U.S.-source "fixed or determinable annual or periodical" ("FDAP"), which includes interest, OID, dividends, rents, salaries, wages, premiums, annuities, and other amounts (not effectively connected with a U.S. trade or business) potentially subject to nonresident withholding under Code sections 1441-42, *and* (ii) gross proceeds from the sale of property that could produce U.S.-source interest or dividends.[13] It should be emphasized that withholdable payments include amounts that are not subject to nonresident withholding (portfolio interest), and, moreover, amounts that do not necessarily correspond to income or gain (gross proceeds from sales of U.S. stocks and securities).[14] The imposition of FACTA withholding on amounts that are not even income highlights the fact that Congress would like the "club" used to compel information reporting to be as powerful as possible.

2. Refunds

Subject to the additional requirement that the identifying information requested be provided, amounts withheld under FATCA withholding rules of section 1471 or section 1472 generally will be refundable to the beneficial owner to the extent that refunds would otherwise be available under the normal nonresident withholding tax rules of sections 1441 through 1446 of the Code. Section 1474(b)(1). Thus, for example, amounts withheld on the payment of gross proceeds or on payments qualifying as portfolio interest, or in excess of the withholding rate prescribed under an applicable income tax treaty, will be refundable to a nonresident that shows its status as beneficial owner and provides the identifying information requested. Amounts withheld from payments beneficially owned by a U.S. taxpayer will be creditable against the taxpayer's regular income tax.

The additional requirement of providing identifying information is consistent with the overall purpose of the FATCA provisions. Thus, no credit or refund will be allowed for tax properly deducted and withheld under sections 1471 or 1472 unless the beneficial owner of the payment provides the Secretary with such information as the Secretary may require to determine whether the beneficial owner of the payment is a USOFE and, if so, the identity of its SUSOs. Section 1474(b)(3).

Special limitations apply where an FFI is the beneficial owner. Section 1474(b)(2) provides that, if an FFI is the beneficial owner of a withholdable payment from which tax properly is properly deducted and withheld under section 1471, a refund is available only to the extent, if any, that the FFE is entitled to a reduced treaty rate, even if the withholdable payment would not have been subject to withholding on the payment under the normal nonresident withholding tax rules.[15] Accordingly, this provision effectively overrides Code sections 871 and 881 with respect to, e.g., portfolio interest and is akin to an excise tax to the extent imposed on a return of invested capital or the receipt of OID accrued prior to the FFI's holding period.

The denial of refunds to beneficial-owner FFIs that are not entitled to treaty benefits may at first blush seem surprising. As indicated above, however, the purpose of the legislation is to pressure FFIs to avoid the new withholding rules by agreeing to the new information reporting regime described above. From this perspective, the denial of all refunds that are not required under an applicable income tax treaty seems entirely logical. Indeed, given that the U.S. Congress has not always been shy about overriding treaties, it is if anything a surprise that the refund-denial provision contains a treaty exception.

Under section 501(b) of the HIRE Act, Code section 6611(e) is amended to provide that the grace period for which the government is not required to pay interest on an overpayment from excess withholding under both sections 1441-42 and new section 1471-72 is increased from 45 days to 180. Pursuant to section 501(d)(3) of the HIRE Act, the increased grace period would apply to refunds of withheld taxes with respect to (1) returns due after the date of enactment (without regard to extensions), (2) claims for refund filed after date of enactment (regardless of the taxable period to which any such claim relates), and (3) IRS-initiated adjustments if the refunds are paid after the date of enactment (regardless of the taxable period to which any such refund relates).

3. *Exceptions to FATCA Withholding*

The section 1471-72 withholding sanction (and hence the requirement to procure information) will not apply to payments to a foreign government and its political subdivisions or their wholly owned agencies or instrumentalities, to an international organization or its wholly owned agency or instrumentality, to a foreign central bank of issue. Section 1471(f). The withholding and reporting requirements also will not apply to payments to a member of a class of persons that Treasury has identified as "posing a low risk of tax evasion." Id. It will be interesting to see which classes of persons are considered low risk.

With respect to NFFEs, the withholding or information reporting requirements also will not apply to payments made to a corporation whose stock is regularly traded on an established securities market or any of its 50% affiliates, to an entity that is organized under the laws of a U.S. possession and that is wholly owned by one or more bona fide residents of the possession, or to a payment of a kind identified by the Secretary as posing a low risk of tax evasion. Section 1472(c). We await guidance on the types of payments exempt as presenting a low risk of tax evasion.

E. Additional Comments on Section 501

1. *General Approach*

As indicated above, the basic approach is to threaten FFIs with a 30% FACTCA withholding on *all amounts* paid with respect to U.S. stocks and securities, including portfolio interest and sales proceeds. In order to avoid this disastrous result, FFIs will have three options. The first option, clearly the desired result of the FATCA regime, is for the FFI to enter into a section 1471(b) agreement and comply therewith, e.g., by reporting all of its U.S. accounts. The second option, which is at least relatively harmless, is for the FFI to opt to have no U.S. customers whatsoever and enter into a simplified agreement with the IRS. Pursuant to section 1471(b)(2)(A), the Secretary may deem an FFI to have satisfied its obligations under its section 1471(b) agreement if it complies with such procedures as the Secretary may prescribe to ensure that the FFI has no U.S. accounts and meets such other requirements as the Secretary may prescribe with respect to accounts that it maintains for other FFIs.[16] The third option, which is not at all the desired result, is for the FFI to disinvest from the United States entirely (and to avoid making investments, including investments in otherwise foreign instruments, through participating FFIs). The great challenge presented by the FATCA regime, and the persons charged with implementing it, is to temper the desire for reliable due diligence and reporting requirements with the need to make those requirements at least minimally palatable to FFIs.

To the extent that FFIs conclude that their obligations (and potential liabilities) under the section 1471(b) agreement would be too burdensome, they will choose the disinvestment option, and the Act will fail to achieve its objectives.[17] Many of the more specific comments below are made in the hope of avoiding this highly undesirable outcome.

Indeed, some progress has already been made in this regard. Section 501 of the Act relaxes some of the more extreme positions in the earlier proposals, which would have, e.g., imposed automatic withholding on U.S.-source amounts paid to any financial institution that is not a QI. Furthermore, the provisions of the Act as ultimately enacted reflect input and incorporate certain suggestions made by various interested parties, including representatives of taxpayers, trade groups and bar associations, as to what type of withholding approach might be workable if a blanket withholding were viewed as necessary to enforce offshore compliance by the guilty few.[18] Nevertheless, further focus on practical difficulties, in consultation with affected financial institutions, is critical.

2. Potential Effect on Foreign Compliance Rules

Depending upon how section 501 of the Act is implemented, other countries may similarly determine to subject entities that are foreign from their standpoint (including U.S. entities) to parallel compliance requirements, with a similar withholding "club" to the extent that the entities derive investment income from such countries. Indeed, the arguments in favor of relying on financial intermediaries to enforce U.S. tax compliance have equivalent merit from the standpoint of foreign tax systems. On the other hand, the cost-benefit analysis for investors and financial institutions may be very different depending upon the country at issue.

As indicated above, provisions of any FATCA-type legislation are avoidable by institutions and investors who are willing to avoid investment in the country with such legislation. We assume that Treasury would prefer that other countries do in fact adopt similar regimes in order that the opt-out choice becomes less attractive and even economically unviable for large investors. Most countries, however, are much less compelling from an investment standpoint than the United States, and even if they are, they may not have the same degree of domestic capital investment base that is able to invest large sums outside of the country and so evade its taxation system, or a legislature as determined to prevent any such evasion.[19] Nevertheless, it is hoped that Treasury and the IRS will be mindful of the risk that similarly burdensome compliance obligations may be visited upon U.S. entities with investments in foreign countries.

3. Broad Definition of Foreign Financial Institution

Section 501 of the Act generally treats not only foreign regulated financial institutions (e.g., a financial institution that accepts deposits in the ordinary course of a banking or similar business) as FFIs, but also any foreign investment entity. This applies regardless of the size of the entity, the size of its investments, or the number of its owners and creditors or accountholders. Foreign entities that are in the business of selling securities to customers, foreign traders for their own accounts and foreign investment vehicles (including family-owned vehicles), as well as offshore securitization vehicles such as CDOs or CLOs, apparently are all treated as FFIs, except to the extent otherwise determined by the Secretary.

Thus, the Act generally subjects such so-called financial institutions to the same exacting requirements as real financial institutions. For example, in the absence of any exceptions, every foreign investment entity however small, and every foreign fund however complex its ownership structure, will be required to enter into a section 1471 agreement or suffer FATCA withholding (which would be refundable unless treaty benefits are available), as the price of holding U.S. stocks or securities (or investing in participating FFIs), even if it has no U.S. contacts beyond such U.S. investments.

While this approach may be needed to some extent to prevent foreign entities and U.S. taxpayers from inappropriately avoiding the regime, many FFIs may decide that the price of investing in the United States is too high and take their business elsewhere. Fortunately, section 1471(d)(5) permits the Secretary to carve out exceptions from the definition of "financial institution," thereby exempting certain foreign entities from the broad definition of FFI. The report prepared by the Joint Committee on Taxation[20] (the "JCT Report") provides that such exceptions may include "entities such as certain holding companies, research and development subsidiaries, or financing subsidiaries within an affiliated group of non-financial operating companies." The JCT Report further states that it is "anticipated that the Secretary may prescribe special rules addressing the circumstances in which certain categories of companies, such as certain insurance companies, are financial institutions, or the circumstances in which certain contracts or policies, for example annuity contracts or cash value life insurance contracts, are financial accounts or United States accounts for these purposes."

It is hoped that, in exercising its authority to determine which exceptions are appropriate, Treasury will consider not only those entities that do not appear to present a significant risk of tax abuse if subjected instead to the NFFE regime, but also those entities that may pose such a risk but where the purposes of the Act would nevertheless be furthered by reducing the impetus to avoid U.S. investments.

One example of an entity that might logically be exempted from FFI status is an investment entity with no more than nine owners. In that event, the entity would simply report its SUSOs under the NFFE rules.[21]

Rules similar to the NFFE rules might appropriately be applied (perhaps electively) even to more widely held funds, possibly on a modified basis such that the 10% NFFE threshold is reduced below 10%. Some flexibility in crafting rules in this regard would diminish the likelihood of certain funds opting out of the system by not holding (or investing in entities holding) U.S. investments, by offering them a basis, short of a section 1471(b) agreement, to provide a requesting FFI that is a party to such an agreement a certification of significant U.S. owners.[22]

It would also seem desirable to exempt payments to the U.S. branch of a foreign bank from the FFI regime, since such a branch already is subject to certain reporting requirements (e.g., Form 1099 reporting)[23] much like a domestic bank. Indeed, the JCT Report indicates that an exception for such U.S. branches may be appropriate, since they are "treated as U.S. payors under present law." The exception would have to be limited to the U.S. branch, however, since the reporting requirements applicable to the U.S. branch would not apply to other parts of the bank.

4. Standards for Determining United States Accounts

Under section 1471(b)(1), a participating FFI will be required, among other things, "to obtain such information regarding each account maintained by such institution as is necessary to determine which (if any) of such accounts are United States accounts." On its face, this appears to be an absolute obligation, and a FFI that does not fulfill such obligation could be subjected, among other things, to FATCA withholding under section 1471(a).

Since FFIs will not be able to successfully identify 100% of their U.S. accounts, they will need to be assured that adopting and following some specified set of procedures, or procedures satisfying certain specified requirements, will be sufficient to fulfill their obligations. Moreover, they will need to feel confident of their ability to develop processes to implement such procedures at a high transaction volume without a significant error rate. Fortunately, section 1471(b)(2)(B) grants Treasury broad authority to exempt FFIs from the requirements of section 1471(b) where it determines FFIs to be members of a class of institutions as to which such requirements are not necessary to carry out the purposes of FATCA. Although not expressly on point, this presumably allows Treasury to promulgate workable guidelines for FFIs to follow regarding the information-gathering and reporting obligations, account holder monitoring, and verification, and to deem a participating FFI that complies with such guidelines to have satisfied its obligations under the 1471(b) agreement.

It is hoped that, in issuing such guidance, Treasury will be mindful of the practical problems faced by FFIs. In particular, it is hoped that FFIs subject to KYC/AML procedures (particularly in countries whose KYC rules have been found adequate for purposes of the QI program) would be permitted to rely on such procedures,[24] and to use information on file for existing account holders. In this regard, the JCT Report helpfully points out that the Secretary "may use existing know-your-customer, anti-money laundering, anti-corruption, and other regulatory requirements as a basis in crafting due diligence and verification procedures in jurisdictions where those requirements provide reasonable assurance that the foreign financial institution is in compliance with the requirements of this provision." It would also be desirable for Treasury to confirm that some relatively minimal amount of errors in following the applicable procedures would be excused.

Government officials have indicated that they are considering more lenient standards for existing accounts as opposed to new accounts, to ease the compliance burden.[25]

The JCT Report also signals potential relief for investors in widely held investment vehicles. "For instance, it is anticipated that the Secretary may provide rules that would permit certain classes of widely held investment vehicles, and to the limited extent necessary to implement these rules, the entities providing administration, distribution and payment services on behalf of those vehicles, to be deemed to meet the requirements of this provision." But presumably such entities would still be considered FFIs and still be required to execute section 1471(b) agreements.

5. Definition of Financial Account

Under section 1471(d)(2), a financial account generally includes depository or custodial accounts maintained by an FFI and any equity or debt interests in such FFI that are not regularly traded on an established securities market (but not contractual interests).

However, U.S. accounts do not include depositary accounts held by individuals in the FFI and, to the extent provided by the Secretary, its 50% affiliates that do not, in the aggregate, exceed $50,000. Section 1471(d)(1)(B). This exception is more lenient than under the prior proposal, which generally would have provided for a $10,000 threshold instead of $50,000 and which would have aggregated an FFI with its 50% affiliates in all circumstances.

Nevertheless, changes are still desirable. First, it would also be desirable to extend the *de minimis* exception to entities. Given that at least some effort and cost must be incurred to establish an overseas account, it seems that this could be done without seriously compromising the objectives of the Act.

Second, the requirement that all accounts maintained by the holder at the FFI be aggregated in applying the de minimis exception is problematic, particularly if the Secretary broadly determines that 50% affiliates must be taken into account as well. Many large FFIs have business units (both branches and legal entities) that operate for the most part separately and therefore would have administrative difficulties in accessing and comparing account information from all business units of the FFI -- and particularly all of its 50% affiliates -- on a cost-effective basis. While they presumably could develop systems at substantial cost to gather and compare the information centrally, the desirability of such a requirement seems doubtful, given that a U.S. investor who truly intends to avoid the rules by splitting accounts could use unrelated FFIs in any event. The definition of U.S. account, as set forth in section 1471(d)(1), does not expressly grant Treasury the authority to formulate additional exceptions.

Treating all debt interests that are not regularly traded on an established securities market as financial accounts also poses difficulties. While such interests may presumably serve as substitutes for depositary or custodial accounts, a broad inclusion of all debt instruments and institutional deposits may unduly increase compliance burdens in view of the frequent and often short-term borrowings by FFIs. Fortunately, the Secretary is authorized to create exceptions to the general definition of financial account. According to the JCT Report, it is "anticipated that the Secretary may determine that certain short-term obligations, or short-term deposits, pose a low risk of U.S. tax evasion and thus, may not treat such obligations or deposits as financial accounts for purposes of this provision."

6. United States Owned Foreign Entities

As indicated above, a U.S. account includes any account of a USOFE, and FFIs must therefore provide identifying information for the SUSOs of such entities. In the case of deposit-taking and custodial FFIs, a U.S. owner is "substantial" only if he, she, or it has a greater-than-10% equity interest. In the case of other FFIs, the 10% threshold does not apply, and every SUSP is therefore considered a SUSO.

Presumably, the reason for eliminating the threshold in such circumstances is that an investment through a foreign investment entity is theoretically comparable to a deposit or custodial account in a regulated entity, where only the $50,000 *de minimis* threshold applies. Nevertheless, some significant percentage threshold, even if less than 10%, is needed to avoid overly harsh compliance burdens that may cause, in particular, investment funds to opt out of the system by avoiding U.S. investments.[26] Unfortunately, the Act does not appear to provide Treasury with the authority to create such exceptions.

7. Verification and Audit Procedures.

As indicated above, participating FFIs will need to implement procedures to comply with their section 1471(b) agreements, and verification would include independent review of such procedures. If the Secretary determines that an FFI is out of compliance, its section 1471(b) agreement may be terminated. Therefore, one critical question for FFIs considering whether or not to participate is how burdensome the verification procedures will be.

It is hoped, for example, that the independent review will be designed to be less onerous than the external audit procedures currently applicable to QIs. Unlike the QI system, which only applies to a limited subset of designated accounts that are chosen for inclusion in a QI arrangement, a section 1471(b) agreement applies to all accounts of the participating FFI (and its 50% affiliates). Some guidance indicating that the requirements should be reasonable under the circumstances, taking into account the costs and burdens, and the capacities of smaller, noninstitutional entities is needed.

8. Procedures Where Information Cannot Be Obtained.

The original FATCA proposal would have required FFIs to collect information on all U.S. accounts and, in any case where this could not be done (e.g., due to a failure to secure waivers of applicable privacy laws), to terminate the account. The current proposal is somewhat more sympathetic to the plight of FFIs in this situation.

Under section 1471(b)(1)(D), a participating FFI that cannot obtain the necessary information from a noncompliant account holder must ordinarily deduct and withhold a 30% tax from all passthru payments to such account holder. Alternatively, the participating FFI may elect under section 1471(b)(3) to have such tax withheld from the withholdable payments that it receives (to the extent allocable to such noncompliant account holders). This alternative may be desirable for FFIs that are unable to impose the withholding tax themselves, or do not wish to administer the withholding process. Of course, an FFI in such circumstances must still get comfortable that it can allocate the burden of the withholding tax solely to the noncompliant account holders and not allocate any portion of such burden on its compliant (i.e., innocent) account holders.

FFIs should not make the mistake of assuming that withholding is a panacea for the information reporting problem. As pointed out in the JCT Report, "[t]he provision allowing for withholding on payments made to an account holder that fails to provide the information required under this provision is not intended to create an alternative to information reporting. It is anticipated that the Secretary may require, under the terms of the agreement, that the foreign financial institution achieve certain levels of reporting and make reasonable attempts to acquire the information necessary to comply with the requirements of this section or to close accounts where necessary to meet the purposes of this provision." In particular, the JCT Report provides that "the Secretary may also require, under the terms of the agreement that, in the case of new accounts, the foreign financial institution may not withhold as an alternative to collecting the required information." Thus, the JCT Report apparently signals a tougher stand on new accounts, which seems entirely reasonable.

Another possible approach would have been to require FFIs to presume all accounts in such circumstances to be U.S. accounts and withhold under the U.S. backup withholding rules or analogous rules. This approach was not adopted.

9. Withholding on Foreign Investments

The FATCA provisions as ultimately enacted address the case in which an FFI makes debt or equity investments in a second FFI (a corporation for U.S. tax purposes) that has U.S. investments, or where an NFFE invests in a corporate FFI with U.S. investments. Although the instruments held by the first FFI and by the NFFE generate foreign source income, such investments will nevertheless be subject to FATCA withholding under section 1471(b)(1)(D) as "passthru payments" to the extent attributable to the withholdable payments received by the FFI with the U.S. investments.[27]

In such circumstances, the so-called "tax" would seem to be in the nature of a penalty for failure to provide information rather than an income tax. Moreover, the imposition of U.S. withholding on foreign-source payments to a foreign entity raises jurisdictional and treaty issues. It may be a sufficient response to such jurisdictional concerns that the "tax" is ultimately tied to U.S. source gross income (or corresponding gross proceeds) and would be avoidable by compliance, and the tax is refundable where compliance subsequently is achieved (not the case where non-treaty FFIs are the beneficial owners, however).[28] Further, Treasury should have existing authority under Code section 7701(l) to issue regulations addressing abusive cases of a conduit nature, and such cases are considered under international tax principles to be fair game for a country to attack. We address treaty issues in part E.10, below.

Even with the above tightening of the legislation, U.S. and foreign investors wishing to avoid compliance could still shift investments to FFIs that themselves have no withholdable payments from the United States. Doing so would not require foregoing exposure to U.S. dollar investments. For example, such investors still could buy U.S. dollar denominated instruments of such an FFI paying foreign source interest.

10. Refunds

Like the nonresident withholding regime under Code sections 871, 881, 1441-1442 and 1445, the new FATCA regime under Code sections 1471-1474 will rely upon the refund system, found in subchapter A of Chapter 3 of the Code, to reverse any overwithholding. Accordingly, great pressure will be placed on this refund system, and procedures will need to be implemented for associating withheld tax with the beneficial owners who are potentially entitled to refunds. How such procedures might work in the case, for example, a noncompliant intermediary or QI is not clear. It is also unclear whether the IRS has the resources to administer a refund process of the scope that would be required.

Special issues arise with respect to the denial of refunds to beneficial-owner FFIs. As indicated above, section 1474(b)(2) denies refunds of properly withheld amounts to beneficial-owner FFIs that are not entitled to treaty benefits. This reflects an improvement over the prior proposal, which arguably would have precluded refunds to beneficial-owner FFIs for improperly withheld amounts.

As indicated above, treaty-eligible FFIs and NFFEs are entitled to refunds of FATCA withholding only if they disclose their SUSOs. To the extent that such information is not germane to the requirements of the treaty, the disclosure requirement may constitute a treaty override.[29] The JCT Report states that the intention is for any guidance provided by the Secretary regarding the applicable documentation and information reporting requirements to be consistent with existing income tax treaties, but this statement may merely indicate that Congress's would like the requirements ultimately imposed to be *construed* as consistent with existing income tax treaties. The United States is clearly unilaterally imposing an additional requirement for a reduced treaty rate, and the requirement typically will not be necessary to show eligibility for such rate under the terms of the treaty itself. One might argue that the refund-denial provision cannot be considered to override income tax treaties, because it is in effect (though not in name, application or administration) an excise tax imposed as punishment for failing to provide the United States with information that it desires. Nevertheless, accepting that argument would make a mockery of income tax treaties, which are intended to limit the tax burden imposed in respect of items of gross (and net) income, regardless of the motivation, and the tax here is in respect of the gross income (as well as gross proceeds).

11. NFFE Diligence.

As indicated above, an NFFE that receives a withholdable payment will be subject to a 30% FATCA withholding unless it either certifies that it has no SUSOs or provides the name, address, and TIN of each SUSO. We assume that "indirect" ownership in the definition of SUSO requires looking through entities, and note that it often is difficult to ascertain ownership through tiers. Accordingly, NFFEs that wish to provide the information necessary to avoid withholding under section 1472 or 1471(b)(1)(D) may simply be unable to do so. The problem will be even more significant if certain relatively passive FFIs are reclassified as NFFEs or permitted to elect the NFFE regime. Guidance is needed concerning the measures that will be considered reasonable for determining indirect ownership.

We believe that regulations will clarify the treatment when an NFFE makes diligent efforts but cannot obtain sufficient information from its owners. For example, if the NFFE receives adequate information as to 80% of its ownership (which, for the sake of simplicity, is all foreign), but cannot obtain information about the other 20% after following all necessary/reasonable procedures (and it is possible that there may be a 10% U.S. owner), it seems a reasonable approach that FATCA withholding be imposed on 20% (and only 20%) of the withholdable amounts and other passthru amounts paid to the NFFE. This would be analogous to the approach taken with respect to payments to an FFI that has entered into a section 1471(b) agreement and has elected to be withheld upon under section 1471(b)(3)(B). The holders of the 20% ownership interests are analogous to recalcitrant account holders of an FFI. Nevertheless, there would remain the commercial problem that the NFFE may not have the legal right to allocate the cost of the withholding tax specifically against the noncompliant owners.

12. Gross Proceeds Withholding.

The risk of suffering FATCA withholding on gross proceeds raises the stakes of being wrong to a very considerable extent, such that numerous entities may well decline to participate and instead opt out of investments in U.S. securities. Therefore, given that withholding on income is still meaningful, it might have been desirable to revisit the question of whether gross proceeds withholding, at least at a 30% rate, is truly a necessary stick.[30] Be that as it may, FACTA defines withholdable amounts to include gross proceeds, so the best that can be hoped for is that other measures will be taken to adequately address the concerns of foreign entities that are quite understandably fearful of FATCA withholding.

II. Repeal of the Foreign Targeted Obligation Exception for Bearer Bonds (Section 502 of the HIRE Act)

Under present law, a "registration-required" obligation that is not issued in registered form generally carries with it punitive tax consequences for both the issuer and the holder: the issuer cannot deduct interest paid or accrued on the obligation and must pay an excise tax equal to 1% of the principal amount of the obligation multiplied by the number of calendar years (or portions thereof) from the date of issuance to the date of maturity; interest paid on the obligation does not qualify for the portfolio interest exemption to the 30% withholding tax on U.S.-source interest imposed by sections 871 and 881; and any loss recognized on the sale or other disposition of the obligation is disallowed to its holder.

When these provisions were enacted, over 25 years ago, Congress determined that U.S. individuals holding bearer bonds created the potential for tax evasion. Congress was also aware, however, that certain markets were primarily bearer bond markets and an important source of debt financing for many U.S. corporate borrowers. The current law and regulations therefore adopted a flexible approach to the problem and permitted issuers to exempt from the registration requirement bearer bonds that are "foreign targeted obligations."

Obligations are "foreign targeted" if there are arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to non-U.S. persons; interest is payable only outside the United States and its possessions; and the face of the obligation contains a statement that any U.S. person holding the obligation will be subject to limitations under U.S. tax laws.[31]

Under section 502 of the Act, the exception for foreign targeted obligations generally is repealed for debt obligations issued more than two years after the date of enactment (on or after March 19, 2010). The delayed effective date is intended to allow ample time for capital markets to adjust.

Thus, foreign targeted obligations will be registration-required obligations and, therefore, subject to 30% withholding tax on U.S. source interest and disallowance of any loss recognized by a holder on a sale or other disposition, unless issued in registered form.[32] However, the foreign targeted obligation exception will still be available with respect to the Code section 4701 1% excise tax applicable to issuers of registration-required obligations that are not in registered form. Section 502(e) (Code section 4701(b)).

Obligations that are issued by a natural person, that mature in one year or less or that are not of a type offered to the public, which are currently excepted from the registration requirement, will be unaffected by the repeal of the exception for foreign targeted obligations.

Section 502 also confirms that a debt obligation held through a "dematerialized" book entry system is treated, for purposes of the registered form requirement, as held through a book entry system. A debt obligation that is formally in bearer form is treated, for purposes of section

163(f), as held in a book-entry system as long as the debt obligation may be transferred only by book entries and the holder of the obligation does not have the ability to withdraw the obligation from the book-entry system and obtain a physical certificate in bearer form in the ordinary course of business. Section 502(c).

Repeal of the foreign targeted exception certainly appears to be a reasonable measure in light of the overall purpose of the FATCA provisions of the HIRE Act. It would be inconsistent with the approach of new Code sections 1471-74 to continue to allow the use of bearer instruments, notwithstanding that they may be structured to meet the rules for foreign targeting rules. Accordingly, the effective elimination of U.S. issuers from the bearer instrument market as a result of the sanctions for registration-required obligations makes sense from a consistency standpoint as a general rule.

There appear to be still, at least for the time being, certain markets in which it is not feasible to issue instrument in registered form (or in bearer form but under arrangements causing them to meet the registered form requirements for U.S. tax purposes, or where they are issued in registered form but the necessary W-8BEN compliance is not feasible). The aspect of the repeal that could potentially affect foreign issuers is the 1% excise tax under Code section 4701. Under section 502(e) of the Act, the section 4701 excise tax is made expressly inapplicable to issuers of instruments that satisfy certain specified requirements for foreign targeted bearer bonds. This exception is narrowly drafted to only encompass the so-called "TEFRA D" provisions that impose documentation and procedural requirements for the exception, however, and will not apply to those instruments that satisfy certain alternative requirements for foreign targeted bearer bonds (where the issuer does not have significant contacts with U.S. commerce). Therefore, foreign issuers wishing to rely on the exemption to avoid imposition of the 1% excise tax of section 4701 will need to be careful to avoid this trap for the unwary.

Further, although in other respects a controlled foreign corporation (CFC) within the meaning of Code section 957 could issue bearer bonds (complying with the foreign targeted rules) just as other foreign issuers, the Code section 312 rules governing earnings and profits accounts would not permit a reduction for the interest expense. Accordingly, distributions from the CFC would be subject to U.S. federal income tax with substantially the same effect (apart from timing) as disallowance of an interest deduction. It is not clear whether this was intended.

III. Substitute Dividends and Dividend Equivalent Payments to Foreign Persons Treated as Dividends (Section 541 of the Act)

Payments of U.S.-source FDAP income, including dividends and interest that does not qualify for the portfolio interest exemption, are generally subject to a 30% withholding tax unless a reduced rate or exemption is available under a treaty. Dividends paid by a domestic corporation are generally U.S. source under section 861(a)(2) and therefore potentially subject to withholding tax.

Under Treasury Regulations, the source of income received under a notional principal contract, however, generally has been determined by reference to the residence of the recipient. Treas. Reg. § 1.863-7(a). Thus, unless recharacterized under common law principles in an abusive (i.e., agency) case, a foreign person's income related to a notional principal contract or so-called “equity swap” that references stock in a domestic corporation, including any amount attributable to dividends paid on the stock, generally has been characterized as foreign source income and therefore not subject to U.S. withholding tax.

Equity swaps have therefore been widely recognized as having the consequence of eliminating a withholdable dividend payment. Further, swaps have been widely marketed as a means of avoiding withholding tax. Consequently, steps to address this issue are understandable.[33]

Section 541(a) of the Act added new section 871(l) to the Code, pursuant to which “dividend equivalent” amounts will be treated as dividends from U.S. sources for purposes of Code section 871 and 881 and consequently subject to U.S. withholding tax under Code sections 1441 and 1442, at the 30% statutory rate or reduced treaty rate. New section 871(l) will apply to any substitute dividends and dividend equivalent payments made (actually or constructively) more than 180 days after the date of enactment (i.e., on or after the 180th day after March 19, 2010).

A “dividend equivalent” is any substitute dividend made pursuant to a securities lending or a sale-repurchase transaction that directly or indirectly is contingent upon (or determined by reference to) the payment of a dividend from sources within the United States and any payment made under a “specified notional principal contract” that is directly or indirectly contingent upon (or determined by reference to) the payment of a U.S.-source dividend. Section 871(l)(1). Thus, section 871(l) codifies the regulatory rule relating to substitute dividends and creates a new source rule for dividend equivalent payments under swaps involving U.S. equities.

A “specified notional principal contract” is any notional principal contract (swap) that has any one of the following five characteristics: (1) in connection with entering into the contract, any “long party” transfers the underlying security to any short party to the contract; (2) in connection with the termination of the contract, any “short party” transfers the underlying security to any long party; (3) the underlying security is not readily tradable on an established securities market; (4) in connection with entering into the contract, any short party to the contract posts the underlying security as collateral with any long party to the contract; or (5) the Secretary identifies the contract as a specified notional principal contract.[34]

The apparent rationale for this rule is that, if one or more of the of the above factors is present, the short party looks “too much” like an agent, holding on behalf of the long party, for dividend withholding tax purposes. The applicability of the new rule does not, however, depend upon any showing of agency under U.S. common law tax principles.

For payments made more than two years after enactment, a specified notional principal contract will also include any notional principal contract *unless* the Secretary determines that the contract is of a type that does not have the potential for tax avoidance. Section 871(l)(3)(B). Thus, the residual rule will be to subject all notional principal contracts with a U.S. stock dividend component to the provision (though substantial regulatory exceptions are anticipated).

Section 541 of the Act also grants Treasury broad powers to identify as dividend equivalents any other transactions or payments that are substantially similar to dividend equivalents under specified notional principal contracts. The JCT Report expressly mentions payments under forward contracts that reference stock of U.S. corporations.

The dividend equivalent amount subject to U.S. withholding tax will be the *gross* amount used in computing any net amounts transferred to or from the taxpayer under the notional principal contract. A party to a total return swap may, therefore, be obligated to withhold and pay tax to Treasury on a gross dividend-based amount even though the party is not required to make an actual payment to its foreign counterparty and therefore has nothing from which it can withhold.

If there is a chain of dividend equivalents, and one or more of the dividend equivalents would be subject to tax under the provision or under section 881, the Secretary may reduce such tax, but only to the extent that the taxpayer establishes that such tax has been paid on another dividend equivalent in the chain, or is not otherwise due, or as the Secretary determines is appropriate to address the role of financial intermediaries in the chain. An actual dividend will be treated as a dividend equivalent for purposes of this section. Section 871(l)(6).

One may reasonably question whether a withholding tax (particularly on a gross basis at a rate comparable to that imposed on net income) on dividends is appropriate tax policy. Nevertheless, U.S. law imposes such a tax, and it therefore seems appropriate to have rules preventing abusive avoidance of the tax. Such transactions may exist under various labels (e.g., equity or total return swap, forward contract, financial contract, etc.).

We also believe that imposing the tax on the gross amount of dividend equivalent amounts even though no net amount may be payable under the swap is appropriate in order to replicate the fact that interest and other amounts payable by the long party that reduce the gross amount under the swap terms would not be deductible for purposes of a gross dividend withholding tax. Whether the short party to the swap should be subject to a so-called withholding obligation where there is no payment from which it can withhold, however, is a separate issue.

For the most part, it seems likely that the outstanding equity swaps adversely affected under section 541 will be terminated, either pursuant to the terms of the swap (i.e., as a result of a Change of Tax Law or Change of Law provision under standard ISDA documentation) or by mutual agreement between the counterparties, to avoid a gross-up for amounts withheld.

The legislation will apply to swaps between two foreign parties. In such a case, if the first foreign party has been subject to withholding on a dividend or dividend equivalent to which the swap relates, the payment to the second foreign party should not again be subject to withholding (other than to the extent the applicable withholding rate on such payment may be higher than the rate applicable to the initial payment). The legislation addresses this issue as noted above. Section 871(l)(6). A similar problem was addressed by the IRS in connection with securities lending.[35]

In a development related to Section 541, on January 14, 2010, the IRS issued an industry directive to provide revenue agents conducting audits with guidance for developing cases involving the use of total return swaps to avoid tax on dividends on shares of U.S. companies paid to foreign persons. The directive is the latest development in the IRS's ongoing efforts to enforce more aggressively the U.S. dividend withholding tax as it affects foreign persons, including offshore hedge funds and is directed primarily at tax periods prior to the effectiveness of Section 541.

The directive will affect audits of both U.S. withholding agents (e.g., financial institutions) and foreign persons (e.g., hedge funds) which the IRS believes have been engaging in dividend withholding tax avoidance transactions. The stated intent of the directive is to provide guidance necessary to determine whether a transaction, which is in form a total return swap, will be respected as a notional principal contract the payments on which are exempt from withholding tax, or whether such a transaction will be recast as some other arrangement or transaction. In particular, the directive mentions three possible recasts that it asserts would result in a withholding tax obligation: (1) an agency relationship, (2) a repurchase agreement, and (3) a lending transaction (presumably a securities lending transaction).

The directive identifies four factual situations that may constitute improper tax avoidance. The first involves cross-in/cross-out transactions in which a foreign owner of a U.S. equity security sells the security to a U.S. financial institution while, at the same time, entering into a total return swap referencing the same security with the U.S. financial institution. After the dividend record date, the foreign person terminates the total return swap and repurchases the securities from the financial institution. The second involves a cross-in/inter-broker dealer out transaction, which is the same as a cross-in/cross-out, except that when the foreign person terminates the total return swap, it reacquires the securities from a third party who is not an affiliate of the financial institution. The third involves a cross-in/foreign affiliate out transaction, which is the same as a cross-in/cross-out, except that the foreign person enters into a total return swap with a foreign affiliate of the U.S. financial institution, and the foreign affiliate enters into a mirror total return swap with the U.S. financial institution. The fourth is a fully synthetic transaction, in which the foreign person has never owned the referenced securities, the financial institution hedges its position under the total return swap, and the foreign person does not purchase the referenced securities when it terminates the total return swap.

For these four situations, the directive directs the agents to develop facts to establish that the foreign person, in substance, retained tax ownership of the U.S. securities even though the physical shares may have been transferred to the financial institution or another party. In this regard, the directive emphasizes the possible existence of unwritten agreements or understandings between the parties involved in the total return swaps.

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[1] P.L. 111-147. These proposals were previously set forth in the Administration's Fiscal Year 2010 budget proposal to Congress, and repeated, without some of the rougher edges, in its Fiscal 2011 budget proposal. FATCA was first introduced as legislation on October 27, 2009 and was reintroduced in the House of Representatives on December 7, 2009 in a revised form reflecting input from various parties as Title V of the Tax Extenders Act of 2009. H.R. 4213. The October version of the legislation was presented at the Conference.

[2] Internal Revenue Code of 1986, as amended (the "Code").

[3] The QI regime, which is expected to continue, involves certain major financial institutions that agree with the IRS to undertake certain diligence, reporting, and verification procedures in the context of the normal section 1441-42 nonresident withholding and/or section 3406 backup withholding regimes, in exchange for the privilege of not disclosing to the IRS or to other intermediaries (potential competitors) the identity of their customers. Unlike the new legislation, the role of these agreements is not to ferret out U.S. offshore investors but rather to help

administer the normal US withholding regime. Thus, no information in respect of foreign source income is required, and U.S. owned foreign entities is not a specific data point.

4 A QI is not required to assume primary nonresident withholding responsibility. Rev. Proc. 2000-12, § 3.02. There are, however, limited circumstances in which a QI that does not assume such primary withholding responsibility must nevertheless withhold under the nonresident withholding rules.

5 A QI that does not assume primary nonresident withholding responsibility must provide the payor of certain "reportable amounts" (including U.S.-source dividends) with a withholding statement that includes, among other things, "withholding rate pool information," so that the payor or other withholding agent will be able to withhold the proper amount under the nonresident withholding rules. Rev. Proc. 2000-12, §§ 6.02 & 6.03. For example, a QI that does not assume primary nonresident withholding responsibility and receives $100 of U.S.-source dividends would advise the payor that $60 of the dividend is subject to nonresident withholding tax at a 30% rate (where treaty benefits are not available) and that $40 of the dividend is subject to nonresident withholding tax at a 15% rate (where one or more applicable U.S. income tax treaties provide for a 15% rate).

6 The backup withholding rate is 28% for 2010 and is scheduled to increase to 31% in 2011. If the FFI is a QI, it can either (1) assume primary responsibility for backup withholding (and 1099 reporting) for certain reportable amounts (including U.S.-source dividends), or (2) provide the payor with the information required to permit the payor or other withholding agent to withhold the proper amount under the backup withholding rules. Rev. Proc. 2000-12, §3.06. There are, however, limited circumstances in which a QI that does not assume such backup withholding responsibility must nevertheless withhold under the backup withholding rules.

7 Interestingly, the standard QI agreement between the U.S. and foreign financial institutions expressly permits a QI to avoid disclosing the identities of its U.S. account holders to the IRS if such U.S. account holders do not invest in U.S. stocks and securities. This loophole was clearly intentional, although it was, of course, not contemplated that QIs would affirmatively use it to promote tax fraud.

8 The failure to report does not necessarily have any relevance to the eligibility of the beneficial owner of the income for exemption or a reduced rate of tax under the normal rules, and would not necessarily even be a failure by such beneficial owner, and the amount withheld often would bear no relationship to any income that is taxable. In general, other than in the case of non-treaty eligible beneficial owner FFIs, the withheld tax will be refundable if the omitted disclosure is subsequently made. Thus, the new FATCA regime bears a passing resemblance to the U.S. backup withholding regime.

9 Including under Code section 1445, dealing with withholding on United States real property interests.

10 A "50% affiliate" is a member of an affiliated group applying the rules of affiliation through a common parent described in section 1504(a), but (1) using a more-than-50% stock ownership threshold for affiliation instead of an 80%-or-more stock ownership threshold, (2) including insurance companies and foreign corporations and (3) including partnerships and other non-corporate entities if 50% or more of the value is directly or indirectly owned by 50% affiliates.

11 Under section 1471(d)(7), the term "passthru payment" means any withholdable payment or other payment that is attributable to a withholdable payment.

12 Presumably, regulations will correct a statutory glitch and require the payments to the electing FFI also to be withheld on to the extent allocable to a second electing FFI.

13 In determining the source of a payment, section 861(a)(1)(B) (the rule for sourcing interest paid by foreign branches of domestic financial institutions as foreign source) will not apply. Sections 1473(1)(B) and (C).

14 Furthermore, in contrast with the existing nonresident withholding rules under Code sections 871(a)(1)(C) and 881(a)(3), withholding on OID would appear to apply to the entire amount of OID accrued through the date of payment, not only the amount accrued while the instrument was held by the payee. A withholdable payment would not, however, include any item of income effectively connected with the conduct of a trade or business within the United States under Code section 871(b)(1) or 882(a)(2).

15 Even in the case of a reduced treaty rate, no interest will be paid in respect of the refund to an FFI that is the beneficial owner.

16 We assume that the Secretary will exercise this authority in a manner that will minimize the compliance burden on FFIs that would like to take advantage of this option.

17 Of course, we do not mean to suggest that the terms of the section 1471(b) agreement will be fully determinative. Other factors would appear to include the relative size and nature of the FFI and the importance of the U.S. market to its owners or clientele.

18 E.g., New York State Bar Association Report No. 1189, Report on Qualified Intermediary and Related Withholding and Information Reporting Legislation Proposal by the Administration, September 10, 2009;

American Bar Association Section of Taxation, Comments on H.R. 3933 and S. 1934, December 3, 2009; New York State Bar Association Report No. 1199, Comments on the Foreign Account Tax Compliance Legislation, January 11, 2010.

19 Query whether blocks of countries, such as the European Union, would be able to effectively act in concert to expand their influence in this regard.

20 Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Act," Under Consideration by the Senate (JCX-4-10, Feb. 23, 2010).

21 Holders of debt or contract rights might also have to be taken into account to prevent abuse.

22 To the extent a fund's interests are held in "street name" (i.e., are publicly traded interests), the fund should be able to enter into a section 1471(b) agreement but avoid FATCA reporting and withholding on that basis. We are not in a position to estimate to what extent interests in funds are so held.

23 E.g., Treas. Reg. § 1.6049-5(c)(5)(i)(F).

24 *See* Treas. Reg. § 1.1441-1(e). Note also in this regard the testimony of Stephen Shay, Deputy Assistant Secretary of the Treasury, Testimony at the House Ways & Means Subcommittee on Select Revenue Measures on November 5, 2009.

25 Foreign Bank Reporting Provision in HIRE Act Is Changing Withholding Landscape, 52 DTR (Mar. 19, 2010) GG-2 to GG-3 (quoting IRS Associate Chief Counsel (International) Steven Musher.

26 See, however, footnote 22 regarding fund interests held in street name.

27 The original proposal did not include the concept of passthru payments and, therefore, would not have required FATCA withholding on any foreign securities.

28 The Government might be tempted to address the issue by purporting to redefine such amounts as U.S. source income; but, except in those relatively few case where a conduit arrangement exists, it does not appear that the relabeling would be particularly meaningful.

29 Under the U.S. Constitution, federal laws and U.S. tax treaties stand on equal footing. Just as a new federal law may repeal or modify an earlier federal law, a new federal law may override an existing U.S. tax treaty. Of course, the propriety or desirably of any such treaty override as a matter of international relations is another matter entirely.

30 Note also that nontaxable amounts such as portfolio interest could still have been included, even if gross proceeds were excluded.

31 Treas. Reg. § 1.163-5(c)(1).

32 Under applicable Treasury regulations, an obligation is "in registered form" if (1) it is registered with the issuer or its agent as to principal and stated interest, and transfer may be effected only by surrender of the old instrument and the issuance of a new instrument or reissuance of the old instrument to the new holder; (2) the right to principal and stated interest may be transferred only through a book entry system maintained by the issuer or its agent; or (3) it is registered with the issuer or its agent as to principal and stated interest, and transfer may be effected through both of the preceding methods.

33 A substitute dividend payment made to the transferor of stock in a securities lending transaction has the same source as the dividend, and substitute payments in respect of a stock lending transaction in respect of stock of U.S. issuers are therefore generally subject to U.S. withholding tax. Treas. Reg. §§ 1.861-3(a)(6), 1.871-7(b)(2) and 1.881-2(b)(2). To avoid multiple inclusions in respect of the same underlying dividend payment, however, Notice 97-66, 1997-2 C.B. 328, limits withholding tax in respect of foreign-to-foreign substitute dividend payments in a manner such that no U.S. withholding tax is imposed on such a payment if the overall U.S. withholding tax in respect of the underlying payments is not reduced. The treatment of stock lending transactions under Notice 97-66, however, can result in withholding tax results similar to those targeted by the swap provision of the Act. Congress held hearings in September 2008 addressing, among other matters, abusive equity swaps and raised concerns that Notice 97-66 was being used by taxpayers to justify tax avoidance transactions, including where a foreign person would lend U.S. stock to a foreign financial institution who would then sell the stock to a related U.S. person and at the same time enter into a total return equity swap with this U.S person. At the hearing, IRS Commissioner Shulman was requested to address the treatment of these transactions.

34 For purposes of these characteristics, for any underlying security of any notional principal contract (1) a "long party" is any party to the contract that is entitled to receive any payment under the contract that is contingent upon or determined by reference to the payment of a U.S.-source dividend on the underlying security, and (2) a "short party" is any party to the contract that is not a long party in respect of the underlying security. An "underlying security" is the security with respect to which the dividend equivalent is paid. Section 871(l)(3).

[35] Notice 97-66. Specifically, U.S. withholding tax on a substitute dividend payment is limited to the amount of substitute dividend multiplied by a rate equal to the excess, if any, of the U.S. withholding tax rate that would have been imposed on the recipient of the substitute payment, if the recipient had received the actual dividend payment directly, over the same rate applicable to the payor of the substitute payment. This amount is further reduced by actual withholding tax imposed on the underlying dividend or substitute dividend payments (if any) earlier in a chain of securities lending transactions. Notice 97-66, section 3.