Second IRS Notice on Implementation of the FATCA Reporting and Withholding Regime

I. INTRODUCTION.

On April 8, 2011, the U.S. Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") released Notice 2011-34 (the "Second Notice"), which is the second notice released to date providing guidance under the Foreign Account Tax Compliance provisions of the HIRE Act ("FATCA").[1]

FATCA, which has a general effective date of January 1, 2013, is intended to prevent U.S. tax evasion by requiring foreign banks and investment funds to provide information to the IRS about U.S. customers and investors. Technically, this is achieved through a comprehensive information reporting regime that requires that all foreign entities be classified as either foreign financial institutions ("FFIs"), non-financial foreign entities ("NFFEs"), or as entities otherwise exempt from FATCA compliance. FFIs generally must conduct diligence on their account holders and investors to determine whether their accounts are "U.S. accounts." Additionally, FFIs generally must either: (i) enter into an "FFI Agreement" with the IRS, pursuant to which the FFI agrees to report to the IRS specific detailed information on their U.S. accounts or (ii) suffer a 30-percent withholding tax on payments made in respect of U.S. securities (and other U.S.-source payments), including interest, dividends and gross proceeds from the disposition of such securities. This withholding tax is imposed on either an account holder if it fails to cooperate with the information reporting process ("recalcitrant account holders"), or an FFI if it does not satisfy its reporting and withholding obligations ("non-participating FFIs").

The Second Notice replaces many of the rules contained in Notice 2010-60 (the "First Notice"), which was published on August 27, 2010 and provided the first set of detailed guidance under FATCA.[2] The Second Notice also provides guidance on topics not addressed in the First Notice, including most significantly the treatment of "passthru payments." Since the enactment of FATCA, Treasury and the IRS have received over one

---

[1] The provisions of FATCA were enacted into law on March 18, 2010 as part of the Hiring Incentives to Restore Employment Act (the "HIRE" Act).

[2] For a discussion of Notice 2010-60, see our memorandum "*First Guidance Regarding Implementation of the FATCA Information Reporting and Withholding Regime*" dated September 8, 2010.

© Cleary Gottlieb Steen & Hamilton LLP, 2011. All rights reserved.

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

hundred comment letters from financial institutions, industry groups, foreign governments and other interested parties, many of which described in considerable detail the operational difficulties that FATCA and the rules described in the First Notice would create.

We believe that the Second Notice represents a genuine attempt by Treasury and the IRS to be responsive to many of the concerns raised in those letters, but the rules contained in the Second Notice create several important new issues and will continue to present significant challenges to financial institutions attempting to comply with FATCA. Part II, below, provides in bullet-point format a very general overview of what we believe are the six most important points concerning the Second Notice, and Part III provides a more detailed summary of the provisions of the Second Notice.

Treasury and the IRS intend to issue regulations incorporating the guidance described in this Notice and addressing other matters necessary to implement the FATCA rules. In addition, Treasury and the IRS intend to publish draft FFI Agreements and draft information reporting and certification forms.

II. EXECUTIVE SUMMARY.

- ***Due Diligence for Preexisting Individual Accounts.*** The Second Notice *modifies the customer diligence rules for preexisting individual accounts* to distinguish between higher-risk and lower-risk accounts, with a more thorough review of the former, as well as a continuing obligation to perform in-depth reviews of information relating to accounts that become higher-risk accounts.
    - The Second Notice requires that all relevant information (including both paper and electronic records) relating to "Private Banking Accounts" be reviewed by the end of the first year following the effective date of the FFI's FFI Agreement, and that a similar review of all accounts worth $500,000 be completed by the end of the second year.
    - All other accounts need to be reviewed only through searches of electronic databases (subject to a requirement to monitor accounts to determine whether they exceed the $500,000 threshold at some later date).
    - The Second Notice also eliminates the requirement that FFIs do a full review of the relevant records for all preexisting individual accounts, or solicit new documentation for such accounts, within the first two or five years (depending on account balance or value) following the effective date of the FFI's FFI Agreement. This change to the diligence rules may substantially reduce the cost to FFIs of vetting their preexisting individual accounts.
- ***Passthru Payments.*** The Second Notice *adopts a broad definition of "passthru payment" that is based on a straight percentage allocation method.* Under this

definition all payments made by an FFI (other than payments made in its capacity as a custodian) that are not otherwise "withholdable payments" will be deemed to be passthru payments to the extent of the FFI's "passthru payment percentage," which is the ratio of the FFI's U.S. assets to its total assets, with look-through rules for cases where an FFI holds interests in another "lower tier" FFI. Custodial payments will be passthru payments to the extent of the issuer of the interest's passthru payment percentage. The broad definition of passthru payment means that an FFI may be required to withhold U.S. tax on interest paid to non-U.S. customers if those customers do not provide all of the information the FFI requests or refuse to waive privacy law restrictions that would prevent an FFI from providing information about those customers to the IRS. Similarly, the broad definition of passthru payment means that an FFI may be required to withhold U.S. tax on interest paid in the ordinary course of business to other financial institutions, for example on interbank deposits, repos, and possibly commercial paper or bills, if the recipient is an FFI that has not entered into an FFI Agreement with the IRS. This broad definition of passthru payment extends the reach of FATCA to taxpayers that may have limited or no contact with the United States.

- ***Exemption for Local Banks.*** The Second Notice provides a potential exemption from many of the most significant FATCA rules for certain local banks, as well as for local FFIs belonging to a larger financial group. Those rules are limited to entities that conduct business only in their local jurisdictions and that to some degree actively avoid account holders that are not resident in their local jurisdictions. These entities ("deemed-compliant FFIs") will not have to enter into an FFI Agreement with the IRS and will not be subject to withholding or reporting requirements, although such entities will be required to apply to the IRS to have their deemed-compliant status confirmed and to make certain ongoing certifications to the IRS.

- ***FFI Groups.*** The Second Notice requires that, in order for an FFI to enter into an FFI Agreement, *each* FFI within the FFI's expanded affiliated group must also agree to do so (or to seek to qualify for an exemption from FATCA). Accordingly, even FFIs within the group that have no U.S. customers and no U.S. accounts generally will be required to enter into an FFI Agreement unless they qualify as deemed-compliant FFIs. The Second Notice contemplates that the group would empower one entity to act as a "lead FFI" that would engage with the IRS on behalf of its affiliates, and that the group might also appoint a "compliance FFI" to establish procedures and policies for the group, monitor compliance, and report on compliance to the IRS.

- ***Separate Branch Reporting Election.*** The Second Notice allows FFIs to elect to report on a branch-by-branch basis, so that branches will not be required to consolidate their customer account information with that of the FFI's other branches. This is intended to alleviate privacy law concerns about sharing information across borders.

- ***Annual Reports.*** The Second Notice simplifies an FFI's reporting requirements on U.S accounts from the complicated rules in the First Notice. An FFI is required to report only the year-end account balance or value of a U.S. account, as well as the gross amount of dividends, interest, and other income paid or credited to the account (which may be determined under foreign law) and any gross proceeds from the sale or redemption of property paid or credited to the account with respect to which the FFI acted as a custodian, broker, nominee or otherwise as an agent for the account holder.

III. NEW GUIDANCE UNDER NOTICE 2011-34.

New Procedures For Examining Preexisting Accounts of Individual Customers.

- Under the rules described in the First Notice, a "participating FFI" (that is, an FFI that had entered into an FFI Agreement with the IRS and thus agreed to supply the IRS with information about its U.S. account holders) eventually would have been required to solicit new documentation from many of its existing account holders (*i.e.*, account holders of accounts held by the FFI as of the effective date of the FFI Agreement) establishing the non-U.S. status of those holders whose accounts had balances of more than $50,000. The First Notice adopted a staggered implementation approach, under which:
    - a full review of electronically searchable databases would have been required within the first year following the effective date of the FFI Agreement; for accounts with a balance of $1,000,000 or more, documentation establishing the non-U.S. status of each individual account holder would have been required within the first two years following the effective date of the FFI Agreement; and for all other accounts in excess of $50,000, documentation establishing the non-U.S. status of each individual account holder would have been required within the first five years following the effective date of the FFI Agreement.
- In response to complaints about the administrative burden and costs associated with implementing the "two year/five year" regime, the Second Notice now replaces that regime with the following rules, which require a full review of accounts deemed to present the highest risk of tax evasion, but limit review of the remaining preexisting accounts to electronic searches.
    - The Second Notice requires a "diligent review"[3] of the *paper and electronic account files and other records* held in "private banking accounts" and generally in accounts containing $500,000 or more.[4]

[3] The Second Notice does not provide a definition of "diligent review."

- Private Banking Accounts. Under the rules described in the Second Notice, an FFI must complete the following steps by the end of the first year in which the FFI's FFI Agreement is in effect with respect to all of its "private banking accounts," which term is defined broadly to include generally all accounts that have been identified as belonging to high-net worth or high-income clients, or with respect to which the FFI provides special personalized services.[5]

    - Each "private banking relationship manager" must identify any private banking client for which the manager has actual knowledge that the client is a U.S. person.

    - For the remaining accounts, each private banking relationship manager must perform a "diligent review" of the paper and electronic files of the manager's private banking clients and identify each account that ─ to the best of the knowledge of the manager ─ has one or more of certain indicia of U.S. ownership.

---

[4] All accounts with balances of $50,000 or less as of the end of the calendar year preceding the effective date of the FFI's FFI Agreement are deemed to be accounts of non-U.S. persons and thus effectively are exempted from FATCA. (This rule represents a change from the First Notice, which would have required an average of periodic balances.) An FFI may elect out of identifying accounts with balances of $50,000 or less and treat all accounts as having balances of more than $50,000. Commentators have noted that monitoring account balances for a $50,000 threshold may be impractical due to currency fluctuations and the general administrative difficulty of monitoring account balances.

Under the Second Notice, for purposes of determining the $50,000 threshold, multiple accounts held by an account holder are aggregated, but only if they are associated with one another under the FFI's existing computerized information management, accounting, tax reporting or other recordkeeping systems. This rule is responsive to concerns raised by FFIs regarding the fact that it may not be operationally feasible (or, in some cases, legal) to cross check information contained in different data systems maintained in multiple jurisdictions or in multiple formats using different and potentially incompatible software. It should be noted, however, that unlike the general account due diligence rules, this rules requires aggregation of accounts held at affiliated FFIs, if the accounts otherwise are associated in the FFI's computer system.

It is unclear if the relief provided by the easier to apply account balance rules, as well as the potentially significant implications of the broad definition of passthru payment, will be sufficient incentives for FFIs to develop the systems to identify accounts with balances of $50,000 or less.

[5] A "private banking account" is any account that is maintained or serviced (i) by a private banking department or (ii) as part of a private banking relationship (generally a relationship in which one or more of the FFI's officers or employees are assigned to (i) provide personalized services to individual clients that are not generally provided to account holders or (ii) gather information about a client's personal, professional and financial histories in addition to the information ordinarily gathered with respect to the FFI's retail customers). Accordingly, the definition of "private banking accounts" may include accounts not held in a traditional or formal private banking department.

- The indicia include information that the account holder *or any associated family member* has U.S. citizenship or a green card, a U.S. birthplace or a U.S. residence or U.S. correspondence address. They also include: standing instructions to transfer funds to an account maintained in the United States; directions regularly received from the United States; an "in care of" address or "hold mail" address that is the sole address of the relevant private banking client; and a power of attorney or signatory authority granted to a person with a U.S. address.[6]

- Once the private banking relationship manager has identified those accounts with "indicia of U.S. ownership" the manager is required to obtain certain specific documentation to determine whether the account is a U.S. account or a non-U.S. account. For example, if the manager finds evidence that an account holder was born in the United States, the manager must obtain either a Form W-9 establishing U.S. ownership, or a Form W-8BEN *and* a non-U.S. passport or other documentation establishing non-U.S. citizenship. In addition, the account holder must provide a written explanation either stating that the client has renounced its U.S. citizenship or explaining why the client did not acquire U.S. citizenship at birth.[7]

- All private banking accounts for which the FFI has *not* — by the end of first year for which the FFI's FFI Agreement is effective — been able to obtain the information discussed above, or to obtain waivers of bank secrecy protections, must be treated as "recalcitrant accounts" until such time as the appropriate documentation or waivers are provided.

---

[6] These indicia are substantially similar to the indicia discussed in the First Notice, but are expanded to cover any associated family members of an account holder. One notable change to the list of "U.S. indicia" is the removal of non-U.S. correspondence addresses (*e.g.*, P.O. boxes) as an indicator of U.S. status due to the fact that in certain countries a significant percentage of the population uses P.O. boxes as their sole address.

[7] The written explanation requirement for non-U.S. account holders with U.S. places of birth is a new requirement from the Second Notice.

- The FFI is then required to report information to the IRS both on its U.S. accounts *and its recalcitrant accounts* on designated “reporting dates” to be prescribed.
  - The Second Notice does not discuss what information an FFI must provide regarding its recalcitrant accounts, so the extent of any conflict with local banking secrecy, data protection or similar laws is not yet clear.
- The government is considering requiring these rules for new individual accounts as well. The principal change from the First Notice would be the requirement to take into account the personal knowledge of private banking relationship managers in identifying customers who are U.S. persons.

▪ Accounts of $500,000 or More (“High Value Accounts”). From among those preexisting individual accounts that have not been identified as U.S. accounts under the rules discussed above, or that have not been identified as having indicia of U.S. ownership under the electronic searches discussed below, the FFI must identify all accounts that had a balance or value of $500,000 or more[8] at the end of the year preceding the effective date of the FFI's FFI Agreement (“high value accounts”).

- The FFI is then required to perform a “diligent review” of the account files “associated with the account” ─ which presumably includes paper and electronic records ─ and obtain appropriate documentation for all accounts containing indicia of U.S. ownership within two years of the effective date of the FFI's FFI Agreement.
  - Account holders who do not provide the necessary documentation or waivers will be treated as holders of recalcitrant accounts.
- *Annual Retesting to Identify New High Value Accounts.*
  - Beginning with the third year following the effective date of the FFI Agreement, the FFI will be required

[8] In determining which accounts have balances or values of $500,000 or more, accounts are aggregated if they are associated with one another under the FFI's existing computerized information management, accounting, tax reporting or other recordkeeping systems.

annually to identify all preexisting individual accounts that have not previously been subjected to the rules for high value accounts discussed immediately above, but that have a balance or value of $500,000 or more as of the end of preceding year. Those accounts must then undergo the "diligent review" and other procedures for high value accounts discussed above.

- ▪ All Other Preexisting Individual Accounts. For all preexisting individual accounts other than those discussed above, the FFI is required to perform a search of its "electronically searchable information" in order to identify those accounts with U.S. indicia, and then obtain the appropriate documentation in respect of such accounts.

    - The Second Notice clarifies that "electronically searchable information" refers to information that an FFI maintains in its tax reporting files, customer master files or similar files that is stored in the form of an "electronic database against which standard queries in programming languages, such as Structured Query Language, may be used." The Second Notice also clarifies that data are not treated as electronically searchable merely because they are stored in an electronic image retrieval system (*e.g.*, PDF files).

    - All accounts with U.S. indicia for which information and waivers have not been received within the first two years following the effective date of the FFI's FFI Agreement will be treated as recalcitrant accounts.

- Certifications Required by Chief Compliance Officer -- Anti-Avoidance Rule.

    - o The Second Notice states that the "chief compliance officer or another equivalent-level officer of the FFI" must certify to the IRS when the procedures discussed above for reviewing preexisting individual accounts have been completed.

    - o The responsible officer must also certify that the FFI's management personnel did not "engage in any activity, or have any formal or informal policies and procedures in place, directing, encouraging, or assisting account holders with respect to strategies for avoiding identification of their accounts as U.S. accounts under the procedures described above" and that the FFI "had written policies and procedures in place as of the date of the FFI's FFI

Agreement prohibiting the FFI's employees from advising U.S. account holders on how to avoid having their U.S. accounts identified."

Expansive Definition of "Passthru Payments."

- Background of Issue.

    - Under the terms of FATCA, a participating FFI must apply a 30-percent withholding tax on all "passthru payments" that it makes to recalcitrant account holders (which are account holders of the FFI that fail to provide requested identification information or who fail to waive any privacy law restrictions that would prevent an FFI from providing information about that account holder to the IRS) and certain other categories of account holders (such as FFIs that are non-participating FFIs and are not otherwise entitled to a special exemption from FATCA).

    - Under the statutory language of FATCA, a passthru payment is defined as including any payment that is "attributable to" a "withholdable payment" received by the FFI (again, generally a payment from U.S. sources or otherwise in respect of U.S. securities, including gross proceeds from the disposition of such securities). Note that withholdable payments do *not* necessarily need to represent income in order to be subject to the tax.

    - Many commentators have noted the potential difficulties in many common situations of determining whether, or to what extent, a payment made by an FFI could ─ or as a policy matter should ─ be considered "attributable to" a withholdable payment received by the FFI.

- The Second Notice Adopts a Straight Percentage Allocation Approach For *All Payments* Made by an FFI to Account Holders.

    - The Second Notice states that a payment made by an FFI will be a passthru payment to the extent of: (i) the amount of the payment that is a withholdable payment (*e.g.,* U.S.-source interest or dividends received through a custodial account); plus (ii) the "passthru payment percentage" of the remaining amount.

        - For payments made other than in the FFI's capacity as a custodian, the "passthru payment percentage" is the FFI's passthru payment percentage, which is the percentage obtained by dividing the value of the FFI's "U.S. assets" over the value of the FFI's total assets.

            - For example, if an FFI holds 1,000 of total assets, of which 200 constitute "U.S. assets," then the FFI's passthru payment

percentage is 20 percent. The effect of that calculation is that *all* foreign-source payments made by the FFI to an account holder in a non-custodial capacity will constitute passthru payments to the extent of 20 percent.[9] If the account holder is a recalcitrant account holder, the FFI will apply a 30% withholding tax on such passthru payments.

- This percentage test applies regardless of whether the account in respect of which a payment is made has any connection to the United States or any connection to U.S. investments. If the FFI in the example above were a U.K. bank, it would have to treat 20 percent of all amounts paid to its "recalcitrant" U.K. depositors in respect of savings accounts, checking accounts, etc. as passthru payments.

▪ For payments made in the FFI's capacity as a custodian, the payment's passthru payment percentage is the passthru payment percentage of the entity that issued the interest or instrument in respect of which the payment is made.

o The Second Notice defines "U.S. asset" generally to include "any asset to the extent that it is of a type that could give rise to a passthru payment."

▪ The Second Notice also states that an FFI's "debt or equity interest" in a U.S. corporation will be treated solely as a U.S. asset, while debt or equity interests in "non-financial foreign entities" ("NFFEs") will be treated solely as non-U.S. assets.

▪ If an FFI holds an interest in another FFI (a "lower-tier FFI") ─ *i.e.,* a debt or equity interest in, or another non-custodial account held with, the lower-tier FFI ─ that interest will constitute a U.S. asset to the extent of the lower-tier FFI's passthru payment percentage.

- This rule suggests that, for a large international financial group, the parent must determine the passthru payment percentage first for each of the lowest-tier members of the group, and then "tier up" the percentages to each higher level of FFIs all the way to the parent (or any other entity in the

[9] These payments would include all interest on bank deposits and payments on derivatives, but would generally not include payments made in the ordinary course of business to third-party providers of non-financial services or payments on publicly traded securities issued by the FFI.

group that has payment obligations to other persons) in order to determine each entity's passthru payment percentage.

- If a participating FFI or "deemed-compliant FFI" (that is, an FFI generally exempted from FATCA, such as certain local banks discussed below) does not calculate or publish its passthru payment percentage, then its passthru payment percentage will be deemed to be 100 percent.

- Non-participating FFIs will be deemed to have passthru payment percentages of zero percent ─ presumably reflecting the fact that passthru payments received by non-participating FFIs will already be subject to FATCA's 30-percent withholding tax, so that a percentage higher than zero would produce over-withholding.

- For purposes of calculating an FFI's passthru payment percentage, the value of an asset is the amount "shown on the quarterly financial statements issued by the FFI for purposes of reporting to its interest holders."[10] Asset values must be calculated quarterly on a "quarterly testing date" and represented in a single currency, which need not be the U.S. dollar.

- Reporting of Passthru Payment Percentages. Each participating FFI will be required under the Second Notice to make its FFI percentage available ─ *e.g.,* on its website or some publicly available database ─ within three months of its quarterly testing date.

- Request for Comments. The Second Notice requests comments regarding possible exemptions from the definition of "passthru payment" that would be consistent with the policy goals of the passthru payment rule, and be reasonable "in light of the potential burden on participating FFIs."

Truly Local Banks May Be Treated as "Deemed-Compliant FFIs."

- The Second Notice provides the following new categories of FFIs that will be deemed to comply with FATCA. However, these deemed-compliant FFIs must comply with certain administrative requirements in order to be treated as such, including (i) applying for deemed-compliant status with the IRS; (ii) obtaining an

[10] The Second Notice does not explain how this rule would apply to subsidiaries within a large financial group. It is possible that a parent entity with consolidated financial statements would be able to use the values of the U.S. and non-U.S. assets on such consolidated financial statements to determine its passthru payment percentage. However, it is also possible that a parent entity would have to multiply the passthru payment percentage of each of its direct and indirect subsidiaries by the net value of the parent's interest in each subsidiary in order to determine the amount of U.S. assets from the subsidiaries includible in the parent's passthru payment percentage calculation.

FFI identification number from the IRS; and (iii) certifying to the IRS every three years that it continues to meet the requirements for such treatment.

- (Truly) Local Banks With Solely Local Affiliates. In order to qualify for deemed-compliant status as a "local bank," an FFI must meet the following requirements, which appear intended to prevent the bank from having any meaningful business with persons outside of the bank's country of incorporation:

    - The FFI must be licensed and regulated as a bank under the laws of its country of organization and must be authorized to accept deposits in the ordinary course of its business.

    - The FFI must not be engaged (or hold itself out as engaged) primarily in the business of investing, reinvesting or trading securities and similar instruments. It is unclear whether mortgage lending banks would be able to use this exemption. While a mortgage loan, as a debt instrument, would be treated as a security for FATCA purposes, a mortgage bank may view its primary role as making loans rather than investing in those loans.

    - All members of the FFI's "expanded affiliated group" (that is, an affiliated group in which each subsidiary is linked to a common parent through 50-percent-or-greater equity holdings) must be organized in the same country.

    - No FFI in the expanded affiliated group can solicit account holders outside of the group's country of organization.

    - Each member of the FFI's expanded affiliated group must implement policies and procedures to ensure that it does not open or maintain accounts for non-residents, non-participating FFIs or entities other than entities engaged in an active trade or business that are organized and operating in the jurisdiction where the FFI is organized ("excepted NFFEs") .

- (Truly) Local FFIs Belonging to Larger Participating FFI Groups. An FFI that belongs to a larger international financial group may qualify for deemed-compliant status if it meets the following requirements:

    - The FFI must maintain *no operations* outside its country of organization.

        - The FFI must not solicit account holders outside its country of organization.[11]

        - The FFI must implement the procedures required of participating FFIs to identify: (i) U.S. accounts, (ii) accounts of non-participating FFIs, and (iii) accounts of NFFEs other than entities engaged in an active trade or business that are organized and operating in the jurisdiction where the FFI maintains the account.

        - The FFI must agree that, if any of the accounts described in the preceding bullet points are identified by it, then the FFI will enter into an FFI Agreement with the IRS, transfer such accounts to an affiliated participating FFI within a reasonable period of time (to be determined in future IRS guidance), or close such accounts.

- Deemed-compliant FFIs will not be required to enter into FFI Agreements with the IRS, and will not be required to comply with FATCA reporting and withholding requirements, although as described above deemed-compliant FFIs will be required to apply to the IRS to have their deemed-compliant status recognized and to make certain ongoing certifications to the IRS.

The Government Is Still Considering Relief for Investment Funds.

- The Second Notice states that certain "collective investment vehicles" and "other investment funds" will qualify for deemed-compliant status if they meet all of the following requirements:[12]

    - All holders of record of direct interests in the fund must be participating FFIs or deemed-compliant FFIs holding on behalf of other investors, or certain entities (*e.g.,* foreign governments and foreign central banks) that are specifically excluded from FATCA.

        - This exemption seems to be intended to apply to a situation in which investment fund interests are held exclusively by custodian banks for investors.

---

[11] As noted on page 18 of this Memorandum, debt issued by an FFI may be treated as an "account" for this purpose, in which case the FFI would not qualify if it had non-local creditors.

[12] Like all deemed-compliant FFIs, they must also (i) apply for deemed-compliant status with the IRS; (ii) obtain an FFI identification number from the IRS; and (iii) certify to the IRS every three years that it continues to meet the requirements for such treatment.

  - o The fund must prohibit the subscription for — or acquisition in the secondary markets of — any person that is not one of the permitted holders described in the immediately preceding bullet point.

  - o The fund must certify that it will calculate and publish its passthru payment percentages in accordance with the procedures contained in the Second Notice (discussed above).

- The rules described above for passthru payments will also apply to investment funds. When an investment fund makes a payment to an investor who has not provided all of the information the investment fund has requested or who refuses to waive privacy law restrictions that would prevent the investment fund from providing information about that investor to the IRS, the investment fund would use its passthru payment percentage to calculate what portion of such payment would constitute a passthru payment.

- *Request for Comments.*

  - o The Second Notice requests comments as to whether certain publicly traded funds (*e.g.,* foreign exchange traded funds) could qualify for deemed-compliant status. The Second Notice then notes that, although publicly traded debt and equity interests in funds do *not* constitute U.S. accounts under the terms of FATCA, if these funds are not deemed compliant, they nonetheless may be required to enter into FFI Agreements, withhold on any passthru payments that it makes to non-participating FFIs, and certify that they will publish their passthru payment percentages as required by the Second Notice.

  - o The Second Notice also requests comments as to whether certain other funds might qualify for deemed-compliant status if they were to put certain procedures in place to limit the types of entities that may invest in the funds (*e.g.,* to prevent U.S. persons and non-participating FFIs from holding fund interests for their own account), and were to meet "other requirements relevant to the purposes of" FATCA.

- *Use of Paying Agents and Transfer Agents by Deemed-Compliant FFIs.* The Second Notice states that, although a deemed-compliant FFI will be responsible for ensuring that it continues to meet the requirements for deemed-compliant status, the deemed-compliant FFI may use a paying or transfer agent to perform necessary due diligence and take any other "required action" associated with maintaining the FFI's deemed-compliant status.

All FFIs in an Expanded Affiliated Group Will Be Required to Enter Into an FFI Agreement.

- The Second Notice effectively states that the question of whether an FFI is a participating FFI will be determined *at the level of the FFI's expanded affiliated group.*
    - Specifically, if any member of an "FFI Group" wishes to qualify for status as a participating FFI, then *each FFI within the group* must enter into an FFI Agreement with the IRS, or qualify as a deemed-compliant FFI.
    - This requirement puts great pressure on determining whether an affiliate is an FFI or a NFFE. In practice, this means that an affiliate that is an FFI with no U.S. customers and no U.S. assets may be required to sign an FFI Agreement and comply with FATCA reporting and withholding requirements unless it is a deemed-compliant FFI.
- The Second Notice begins to set out a process by which an expanded affiliated group will be able to comply with FATCA requirements at the group level.
    - The Second Notice contemplates a process whereby each member of the group appoints a "lead FFI" legally empowered by its FFI affiliates to apply for participating FFI status (or deemed-compliant status) for all group members and complete the process with the IRS on their behalf.
        - Notwithstanding the "lead FFI" concept, the Second Notice is clear that each individual FFI will be responsible for its own due diligence, withholding and reporting obligations, and other obligations under its FFI Agreement.
    - The Second Notice also contemplates that the lead FFI will continue to act as a central contact point for the IRS with respect to the group's ongoing compliance obligations. The lead FFI will be permitted to appoint one or more affiliates to act as points of contact for particular entities or groups of entities, which may be helpful for large affiliated groups that maintain separate lines of business.
    - The Second Notice also contemplates that a specific FFI could be designated by the group as a "compliance FFI" to assume an oversight role for compliance by the group with the requirements of FATCA. Compliance FFIs would be tasked with establishing policies and procedures to be followed by the group members, ensuring compliance with those procedures, and reporting to the IRS regarding compliance.

- In this regard, the Second Notice states that Treasury and the IRS are also considering whether a "centralized compliance option" should be available for investment funds that are associated with a common asset manager or other agent.

Branch Reporting Election.

- The Second Notice states that FFIs will be allowed to elect for each branch to report information (or to make an election to be withheld upon) on a *standalone basis.*[13] This rule responds to comments to the effect that branches of an FFI located in different jurisdictions may be prevented by local law from consolidating account holder information with information held in other branches.

Reporting on U.S. Accounts.

- ***Account Balance or Value.*** With regard to the requirement under FATCA that a participating FFI report the balance or value of each of its U.S. accounts to the IRS, the Second Notice allows the FFI to use *year-end account balances or values* for this purpose. This rule replaces the rule contained in the First Notice, which looked to the highest of the month-end balances or values during the year (or the highest of the relevant periodic balances or values in cases where the FFI reports to its account holders less frequently than monthly). This change is intended to be responsive to comments that banks may lack the data or systems necessary to calculate account balances or values according to the rules in the First Notice.

- ***Gross Receipts and Withdrawals.*** The Second Notice also states that a participating FFI will be required to report annually the following information regarding its U.S. depositary accounts and custodial accounts:

  - The gross amount of dividends paid or credited to the account;

  - The gross amount of interest paid or credited to the account;

  - Other income paid or credited to the account;

  - Gross proceeds from the sale or redemption of property paid or credited to the account with respect to which the FFI acted as a custodian, broker, nominee or otherwise as an agent for the account holder.

---

[13] It is not entirely clear how this rule will interact with the centralized compliance rules with respect to client account diligence, which appear to require that all branches engage in a single process.

- This change is responsive to the concern that it would be difficult to document the cash in and cash out of every account. Instead, the Second Notice uses concepts (*e.g.*, "dividends") that are likely to be on account statements produced by FFIs. Additionally, for these purposes, the character and amount of payments need *not* be determined in accordance with U.S. federal income tax principles. Instead, the FFI may apply the same principles that it uses to report information on the accounts to its local tax administration, or if no such reports are made, then in the same manner used for making reports to the account holder.
  - If reports are made neither to the local tax administration nor to account holders, then the FFI is required to determine such amounts either in accordance with U.S. federal tax principles or in accordance with any reasonable method of reporting consistent with the accounting principles generally applied by the FFI.
  - If an FFI does not have current systems to collect this information, it will have to develop systems to allow it to do so, which could be an additional administrative burden.
- The Second Notice helpfully provides that FFIs that are not otherwise U.S. payors for purposes of the U.S. information reporting rules and that generally comply with the reporting requirements relating to gross receipts and withdrawals will not be required to comply with the new U.S. tax basis reporting requirements.
- If the FFI retains copies of statements sent to account holders in the ordinary course of its business, the Second Notice requires those statements to be retained for a period of five years and to be made available to the IRS upon request.

Requirements for Qualified Intermediaries and Similar Entities.

- The Second Notice clarifies that "Qualified Intermediaries," "Foreign Withholding Partnerships" and "Foreign Withholding Trusts" will be required to consent in their current agreements with the IRS to become participating FFIs.

Issues Not Addressed by the Second Notice.

- While the Second Notice attempts to address concerns raised by commentators with respect to the FATCA rules and the guidance provided by the First Notice, there are a number of other issues that have been the subject of numerous comments and on which FFIs, USFIs, and others have been seeking guidance.
  - Key Definitional Issues. There are significant terms used in the FATCA rules and Notices that have yet to be defined. The definition of FFI includes an entity "engaged *primarily* in the business of investing, reinvesting, or

trading of securities" or that holds financial assets for the account of others "as a *substantial portion* of its business." The highlighted terms have not been defined, and it is not clear what level of activities of this kind will cause an entity to be classified as an FFI.

- Treatment of Debt of FFIs. It is unclear when a debt interest is "regularly traded on an established securities market" for the purpose of determining whether such an interest would be treated as a financial account. If a debt instrument is not "regularly traded" it will be treated as an account that will be subject to withholding and reporting with respect to the FFI's creditors.
  - There is a critical need for guidance regarding any exception from the definition of "withholdable payment" for the very large market for commercial paper and other short-term debt instruments. These instruments are considered low risk and are a large part of the funding base for financial institutions. They generally are exempt from withholding tax and information reporting.
  - The definition of "regularly traded" also applies to equity interests. It is unclear whether equity interests in an investment fund that are not traded on an exchange will satisfy the "regularly traded" test. For banks, this term is most significant for purposes of preferred stock since a bank's common stock ordinarily would be publicly traded.
- Retirement Plans. The Second Notice states that Treasury and the IRS are continuing to consider the question of which foreign retirement plans (other than those falling into the narrow category of plans described in the First Notice) should qualify for deemed-compliant status, but provides no additional guidance as to their thinking on the issue.
- Insurance Companies. There is no further guidance regarding whether or to what degree insurance companies will be treated as FFIs.
- Investment Funds. There is very little guidance on applying the FATCA rules to funds, especially which funds may be deemed compliant.
- Exempt Beneficial Owners. There is no guidance regarding the details of the exemptions provided for certain classes of beneficial owners (*e.g.*, foreign governments or regularly traded corporations and their wholly owned subsidiaries), including addressing definitional issues that are critical to determining the breadth of these exemptions. There is also no guidance regarding the manner in which such persons may establish their eligibility for exemption.

- Conflicts with Foreign Law. A substantial number of comment letters have raised concerns regarding a number of ways in which obligations imposed under FATCA may require FFIs to violate local law. The two Notices have generally not addressed these concerns.

- Chapter 3 Overlap. While both Notices acknowledge that there are significant issues regarding overlapping responsibilities between FATCA withholding and the existing U.S. federal withholding tax rules, neither provides any significant guidance with respect to the coordination between many existing withholding and reporting provisions of the Code and the withholding and reporting regime introduced by FATCA.

- Refunds. Commentators are concerned that there may initially be significant overwithholding under FATCA as FFIs develop their FATCA compliance systems. There is currently no guidance that addresses the technical and practical difficulties that non-U.S. investors may experience in obtaining refunds with respect to overwithheld amounts.

- TEFRA. The HIRE Act generally eliminates U.S. issuers' ability to issue debt in bearer form, by repealing the long-standing "Eurobond exception" to the "TEFRA" restrictions on the issuance of bearer debt. In connection with this change, the HIRE Act also broadens the definition of "registered form" debt obligations. Neither Notice provides any guidance with respect to a number of technical issues that are raised by these changes.

If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under "Tax" under the "Practices" section of our website at http://www.clearygottlieb.com.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

CLEARY GOTTLIEB

Office Locations

New York
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

Washington
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

Paris
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 40 74 68 88 Fax

Brussels
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

London
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

Moscow
Cleary Gottlieb Steen & Hamilton LLC*
Paveletskaya Square 2/3
Moscow, Russia 115054
7 495 660 8500
7 495 660 8505 Fax
* an affiliate of Cleary Gottlieb Steen & Hamilton LLP

Frankfurt
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

Cologne
Theodor-Heuss-Ring 9
50688 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

Rome
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

Milan
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

Hong Kong
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

Beijing
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax

Buenos Aires
CGSH International Legal
Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
54 11 5556 8900
54 11 5556 8999 Fax