KPMG analysis of the FATCA proposed regulations

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The Treasury Department and IRS on February 8, 2012, released for publication in the *Federal Register* proposed regulations (REG-121647-10) for the Foreign Account Tax Compliance Act (FATCA).

Since the enactment of FATCA in March 2010, Treasury and the IRS have issued several rounds of preliminary guidance. The recently released proposed regulations have been much anticipated by taxpayers that expect to be affected by the new FATCA withholding and reporting regime, particularly in light of the looming January 1, 2013 (July 1, 2013, for foreign financial institutions) effective date.

Background

In an effort to curb perceived tax abuses by U.S. persons with offshore bank accounts and/or investments, Congress passed broad, sweeping legislation intended to combat offshore tax evasion by such persons. Specifically, FATCA, signed into law on March 18, 2010, incorporates a new Code chapter 4 reporting regime that is designed to achieve this stated intent by imposing a penal withholding tax on certain foreign entities that refuse to disclose the identities of these U.S. persons.

The statute, while providing very general information with respect to the new withholding and reporting rules, defers much of the administration and implementation of the new regime to Treasury and the IRS. Prior to the release of the proposed regulations, Treasury and the IRS had issued three Notices, 2010-60, 2011-34, and 2011-53, which provided very preliminary guidance with respect to the new regime The proposed regulations take us one step closer to understanding how Treasury and the IRS intend to carry out the new regime.

The preamble to the proposed regulations provides that Treasury and the IRS carefully considered stakeholders' comments in an effort "to develop an implementation approach that achieves the appropriate balance between fulfilling the important policy objectives of chapter 4 and minimizing the burdens on stakeholders." Significantly, they reiterated their intent to continue the dialog between interested stakeholders, including foreign governments, as they finalize these rules. With respect to the dialog with foreign government, the preamble sets forth the possibility of an alternative reporting regime that contemplates foreign financial institutions (FFIs) located in a participating country (or, one that has entered into an intergovernmental agreement with the Department of Treasury) reporting the FATCA information directly to their local authorities who, in turn, would exchange the information with the United States.

Executive summary

As mentioned above, the IRS issued several rounds of preliminary guidance prior to the release of the proposed regulations. According to the preamble, the proposed regulations incorporate the guidance contained in the IRS notices, but also provide guidance on topics that were not addressed in the FATCA-related notices. Several of those key provisions are summarized in the following discussion:

- Extension of the transition period for the scope of information reporting and withholding on passthrough payments

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- Modification of due diligence procedures for the identification of accounts
- Transitional rules for affiliates with legal prohibition on compliance
- Refinement of the definition of financial account
- An expanded scope of "grandfathered obligations"

Extension of the transition period for the scope of information reporting and withholding on passthrough payments

The proposed regulations provide additional transition relief related to reporting and withholding. Notice 2011-53 provided that the first reporting requirement under FACTA would take place in 2014 (for U.S. accounts maintained in 2013). In addition, it provided that the requisite withholding on any passthrough payments, that is not a withholdable payment, made by a participating FFI (PFFI) to recalcitrant account holder (a nonparticipating FFI) (NPFFI)) would take place no earlier than January 1, 2015.

For reporting, the proposed rules phase in the information that is required to be reported over a period of years. In 2014 and 2015 (for accounts maintained in 2013 and 2014), the information will be limited to name, address, TIN, account number, and account balance information. The following year, any income paid to the account must also be reported. Finally, in 2017, all of the above information, as well as gross proceeds paid to the account would also be required. This phased-in approach with respect to the reporting requirements was in direct response to commentators that had voiced concerns regarding necessary system changes for the reporting of income and proceeds.

To date, the requirement for an FFI to impose withholding on passthrough payments has been one of the most debated and contentious areas of the new regime. Given the complexity and legal questions surrounding this requirement, Treasury and the IRS have decided to further delay the issue by providing that this withholding would not be required on any foreign passthrough payments (the portion of a passthrough payment that is not a withholdable payment) before January 1, 2017.

Modification of due diligence procedures for the identification of accounts

The proposed regulations have completely eliminated the heightened scrutiny for accounts that previously fell within the broad definition of "private banking." Instead, the heightened scrutiny is based solely on a $1 million dollar threshold.

Significantly, the requisite paper search for U.S. indicia for these accounts has also been scaled back to include only more recent account data (as opposed to a search of every paper document on file). In addition, the de minimus threshold has been raised to $250,000 for entity accounts, as well as for the cash value of insurance policies. Finally, the proposed rules extend the reliance on existing anti-money laundering (AML) and "know your customer" (KYC) procedures for pre-existing account identification.

These modifications are viewed as being welcomed and as demonstrating that Treasury and the IRS are listening to the voice of industry.

Transition rules for affiliates with legal prohibitions on compliance

Earlier guidance had indicated that each FFI member within an expanded affiliated group must be either a participating FFI (PFFI) or a deemed complaint FFI (DCFFI). In the proposed regulations, Treasury and the IRS recognize that this is not possible for certain FFIs organized in jurisdictions with laws that prevent an FFI from fully complying with the withholding and reporting requirements of FATCA.

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To that end, the rules adopt a two-year transition period, until January 1, 2016, for FFIs in such jurisdictions to become compliant with the initial rule. In the interim period, such FFIs must, among others, agree to perform the account identification procedures to identify U.S. accounts. It is important to note that these FFIs will be subject to the penal withholding on withholdable payments during this time.

Refinement of the definition of financial account

The proposed regulations refine the statutory definition of a financial account (depository account, custodial account, or debt or equity interest in an FFI, other than those that are regularly traded) by focusing on the traditional meaning of these accounts and excluding certain retirement savings accounts and other tax favored non-retirement savings accounts. In addition, as indicated in the preliminary guidance, the definition of a financial account also includes an insurance contact with a cash value.

Expanded scope of grandfathered obligations

Pursuant to the statute, a withholding agent would not be required to impose FATCA's penal withholding on any payments—including the gross proceeds from any disposition—related to an obligation that was outstanding on March 18, 2012.

The proposed regulations extend this relief by excluding, from the definition of withholdable or passthrough payment, any payment made under an obligation outstanding on January 1, 2013. For purposes of this relief, the definition of an obligation set forth in earlier guidance remains substantially the same.

Given the many compromises in the proposed regulations, tax professionals note it is clear that Treasury and the IRS did, in fact, listen and respond to certain stakeholder concerns, as indicated above. Further, the fact that they have articulated a clear intent to continue such dialog is welcomed news. Given the breadth and complexities inherent in the new regime, coupled with the fact that there remain several significant uncertainties, affected persons will undoubtedly want to continue their efforts in this regard.

To that end, below is a general overview of the provisions contained in the proposed regulations, with commentary regarding some of the more functional provisions as well as others that may need to be revisited.

Section 1.1471-1 – General scope, purpose, and definitions

Section 1.1471-1 describes the purpose and scope of the new regime. It provides general definitions for terms specific to chapter 4, as well as cross references to those used in the current withholding and reporting regimes (chapter 3 and 61 of the Code). Significant to this, the preamble provides that Treasury and the IRS intend to revise certain definitions set forth in the regulations under chapters 3 and 61 so that they conform to the chapter 4 definitions.

Section 1.1471-2 – Requirement to withhold on payments to certain FFIs

Section 1.1471-2 provides the general rules requiring the imposition of withholding on any payment of fixed or determinable annual or periodical income (FDAP) made to a nonparticipating FFI (NPFFI) after December 31, 2013. It further provides which participating FFIs (PFFI) can make the section 1471(d)(3) election ("(d)(3) election") to have their upstream payor withhold chapter 4 taxes on their behalf.

In general, a qualified intermediary (QI) that has assumed primary withholding responsibility under chapter 3, a withholding foreign partnership (WP), and withholding foreign trust (WT) may not make a (d)(3) election and, instead, is required to also assume withholding responsibilities under

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chapter 4. Conversely, nonqualified intermediaries and QIs that do not assume chapter 3 withholding responsibilities will be required to make the (d)(3) election and have their upstream payor withhold.

When determining whether withholding is required on a payment with respect to a pre-existing obligation when the withholding agent does not have valid documentation, the proposed rules provide that withholding will not be required prior to January 1, 2015, unless the payee is a prima facie FFI. For this purpose, a prima facie FFI is one where the withholding agent has, in its electronically searchable files, an indication that the payee is a QI or NQI, or, for accounts maintained in the United States, where the account is documented or presumed to be a foreign entity and the withholding agent has in its electronically searchable file certain North American Industry Classification codes or Standard Industry Classification codes that indicate the payee is a financial institution. Thus, a U.S. withholding agent has one year to document a pre-existing account held by a prima facie FFI before it must begin imposing chapter 4 withholding and two years for all others.

Section 1.1471-2 also provides a significant clarification relating to a much debated issue. Specifically, the proposed regulations make clear that, similar to the rules in chapter 3, an unrelated withholding agent is not obligated to withhold under chapter 4 when it lacks knowledge of the facts giving rise to the payment. The corresponding example makes clear that a withholding agent, including a PFFI, that is merely following a wire transfer instruction would not be required to impose chapter 4 withholding when it has no knowledge of the facts surrounding the payment (e.g., does not know the type of payment being made or whether withholding has already been imposed).

Finally, the proposed section 1.1471-2 rules extend the withholding relief associated with certain grandfathered obligations. Pursuant to the statute, no chapter 4 withholding is required for any payment on an obligation that is outstanding on March 18, 2012. The proposed regulations extend this date to January 1, 2013. Among other stated requirements, to fall within this category, the obligation must contain a definitive term. While the insurance industry had hoped that all pre-existing cash value policies would fall within this exception, the proposed rules make clear that a life insurance policy, payable only at death, does not have the requisite definitive term.

Section 1.1471-3 – Identification of payee

Section 1.1471-3 provides the proposed rules that a withholding agent must apply to establish the status of the payee for purposes of chapter 4 (e.g., PFFI, DCFFI, NPFFI, certified DCFFI, active NFFE, etc.). Specifically, this section provides detailed guidance as it relates to payee documentation, related due diligence, as well as presumption rules that a withholding agent must apply when it lacks valid documentation for an account.

Documentation

With respect to documentation, proposed section 1.1471-3 generally permits a payee to self certify its chapter 4 status on IRS Forms W-8 and Form W-9. When the payee is claiming status as a certified DCFFI, however, the rules impose additional verification requirements on the withholding agent to corroborate the payee's claim. Further, with the exception of the certified DCFFIs, the rules generally provide transition relief for certain payments made prior to January 1, 2017. For example, a U.S. withholding agent may rely on: (1) an existing Form W-8BEN and (2) organizational documents, financial statements, credit reports, or a SIC Code to establish a payee's claim that is it an Active NFFE when the payment is made prior to 2017, on an obligation that was in existence on January 1, 2013.

The preamble further provides that the IRS intends to revise the current Forms W-8 and Form W-9 to allow a payee to use the same form to certify its status for both chapter 3 and chapter 4 on the same form. The preamble provides that a withholding agent may continue to accept the prior

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version of the form for six months after the release of the new forms, unless the IRS indicates otherwise in future guidance. In addition, the withholding agent generally may rely on a form signed prior to the release of the revision until its validity expires.

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Withholding agents are expected to be relieved to see that Treasury and the IRS have abandoned their long-standing position that, aside from a limited 90-day grace period, a Form W-8 may not be transmitted via facsimile.* In addition, the rules provide that a withholding agent may obtain the tax form 15 days after the date of payment without a need to obtain a retroactive affidavit. For forms received within the year following the date of payment, a retroactive form is permissible. Finally, when the documentation is obtained more than a year after the payment date, a retroactive form plus corroborating documentary evidence would be required.

*Though the rules do state that the withholding agent must confirm that the person furnishing the faxed form must be the person that is named on the form, it is unclear what such confirmation would entail.

Due diligence – "Reason to know"

The section 1.1471-3 due diligence rules—relating to when a withholding agent has "reason to know" that documentation is incorrect or invalid—are modeled very much after the existing chapter 3 rules. Specifically, the general rule provides that a withholding agent has reason to know that documentation is invalid when a "reasonably prudent person in the position of a withholding agent" would question the claims made.

As in chapter 3, the rules continue with specific fact patterns when a withholding agent would have such "reason to know," and the requisite curative documentation that it must obtain before it can accept the payee's original claim. These so-called "red flags" are very similar to those set forth in the chapter 3 rules (e.g., U.S. address, or, for offshore obligations, standing instructions to pay inside the United States).

In addition, the chapter 4 proposed rules add two more flags that withholding agents need to be looking for when a payee claims foreign status—U.S. birthplace and U.S. telephone numbers.

One very important distinction between the two sets of rules, however, is the clear safe harbor language in the chapter 3 rules. For withholding agents that are financial institutions, the chapter 3 due diligence rules limit the circumstances of "reason to know" to those specifically stated in the regulations. Unfortunately, that same safe harbor language is missing from the section 1471 proposed rules. While this may have just been a simple drafting oversight, the uncertainty will, undoubtedly, cause problems for many affected withholding agents as they endeavor to establish clear procedures for personnel charged with determining whether documentation is valid.

Presumption rules

The section 1.1471-3 proposed rules also provide presumption rules that the withholding must apply when: (1) it either has no documentation; or (2) the documentation it does have is invalid or incorrect.

Again, very similar to the rules set forth in chapter 3, the proposed chapter 4 presumption rules provide that when the payee appears to be an individual from the name or other account documents, the withholding agent must presume the payee to be an individual. When such a determination cannot be made, the withholding agent must treat the payee as an entity. Once the withholding agent determines the payee's classification, the rules provide a general presumption that the payee is a U.S. person. As with chapter 3, however, there is an exception for an entity with foreign indicia. Specifically, the withholding agent must presume an entity is foreign when it: (1) has the payee's EIN and begins with "98"; (2) mails communications to the payee at an address outside the United States; (3) has a non-U.S. telephone number for the payee; or (4) the payee is listed on the per se list of foreign corporations.

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One of the most significant differences in the two sets of presumption rules is the proposed chapter 4 rule that requires a withholding agent to treat certain exempt recipients (e.g., corporations, financial institutions, and brokers) as foreign persons. For decades, the current rules have permitted withholding agents that can "eyeball" a payee as an exempt recipient to treat it as such without obtaining documentation. As a result, the vast majority of withholding agents, including those making nonfinancial payments, do not have Forms W-9 on file for these exempt recipients.

Under the new rules, if a U.S. withholding agent does not obtain a Form W-9 from a U.S. corporation by January 1, 2015, it must treat the entity as a NPFFI and impose the chapter 4 penal withholding on any withholdable payment made after that date. Moreover, the requisite date for the imposition of the chapter 4 withholding is likely January 1, 2014, for any withholdable payments made to a U.S. financial institution or broker. This is because, under the documentation rules, such an entity would likely fall within the prima facie FFI category because the withholding agent likely maintains a financial SIC Code for the payee in its electronically searchable files.

It is important to note that the preamble states the current presumption rules under chapters 3 and 61 will be revised to correspond to the proposed rule outlined above. This would effectively eliminate the long-standing eyeball test for these exempt recipients—something that is certain to take many withholding agents by surprise. It also means that many nonfinancial institutions that would not be affected by the FATCA rules because of the exclusion of ordinary business payments from the definition of "withholdable payments," (see section 1.1474-1 below) will nevertheless be greatly affected. With the above mentioned revision to the chapter 3 and 61 presumption rules, a significant portion of a nonfinancial company's accounts payable vendor population (i.e., U.S. corporations) may be undocumented and, thus, required to be presumed to be foreign under the new rules. As a result, the 30% withholding under chapter 3 of the code would be required—an undeniable trap for the unwary.

Finally, when the withholding agent's actual knowledge or "reason to know" would result in withholding that would not otherwise be imposed under the presumption rules, the withholding agent must apply the rules based on its actual knowledge or reason to know. This circles back to the question posed above regarding when a withholding agent should have reason to know that documentation is invalid for chapter 4 purposes and, specifically, whether the factual circumstances delineated in the proposed regulations was meant to be a safe harbor.

Section 1.1471-4 – Requirements of FFI Agreement

Section 1.1471-4 sets forth the general requirements that will be contained in the "FFI Agreement." The preamble provides that Treasury and the IRS intend to release a proposed FFI Agreement in "early 2012," with the final document to be released in the Fall of 2012.

Modification to prior guidance—Pre-existing account identification

The proposed regulations incorporate substantial changes for the pre-existing account identification rules for FFIs. Specifically, the rules:

- Eliminate the private banking designation and increase the dollar threshold for pre-existing individual accounts subject to the "enhanced review" to $1million
- Provide that the manual review for pre-existing accounts is not required if certain data is maintained electronically (namely, nationality and/or residence status, current residence and mailing addresses, current telephone number(s), whether there are any standing instructions, whether there is only an "in care of" address or "hold mail" instruction, and

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if there are any power of attorney (POA) or signatory authorizations)

- Provide that when the paper search is required, the scope under the proposed regulations limits such search to: the current customer master file, and if not contained in that file, any of the following documents if received by the FFI within past five years:
    - Most recent: documentary evidence, account opening contract, AML documentation, as well as any power of attorney or payment instruction currently in effect.
- Raise the de minimis threshold for pre-existing entity accounts to $250,000. Further, when the de minimis threshold exception is applicable ($50,000 for individuals or $250,000 for entities), there is no requirement to apply the due diligence procedures to the account until the account balance reaches $1 million (unless the account has otherwise been identified as a U.S. account)

Notwithstanding the very positive development with respect to the pre-existing account identification rules, two other proposed rules in section 1.1471-4 leave FFIs operating in jurisdictions that have privacy laws that prohibit the disclosure of information to the IRS in a precarious situation: (1) the reporting requirements for NPFFIs; and (2) the limited FFI transition rules.

Reporting requirements to NPFFIs

The proposed reporting rules set forth in section 1.1471-4—which cross reference the proposed section 1.1474-1 rules, contemplate that, beginning in 2017—a PFFI would be required to report, on a separate basis, each payment subject to chapter 4 that its makes to each NPFFI. Prior to that time, a PFFI is permitted to report the portion of the payment that relates to non-U.S. source income in the aggregate.

Notwithstanding the aggregation of payments, however, reporting is still required to each NPFFI. That is, the transition rule does not permit the reporting for all payments made to NPFFIs to be completed on a pooled basis. As mentioned, this poses a challenging situation for an FFI located in a jurisdiction that prohibits reporting without a waiver.

It is interesting to note that the reporting rules permit a PFFI to report, on an aggregated basis, the payments made to recalcitrant account holders. The payee-specific NPFFI reporting problem is compounded by the fact that the transition relief intended to remedy such local law prohibitions (i.e., the limited FFI concept) expires in 2015.

Limited FFI –-Transition rule

The limited FFI concept was adopted to help certain FFIs within expanded affiliated groups.

The proposed rules provide that all FFIs within an expanded affiliated group must either be a PFFI, DCFFI, or otherwise exempted from the rules.

Understanding that certain FFIs operate in jurisdictions that prohibit disclosures of account holder information, closing of recalcitrant accounts, etc., Treasury and the IRS devised a transition rule for "limited FFIs." Specifically, the limited FFI rule would apply when an FFI within an expanded affiliate group is legally prohibited from either:

- Reporting and closing account or transferring an account, or
- Withholding and blocking, closing, or transferring an account*

*While the proposed regulations do not currently read the same, the description of FFIs eligible for limited FFI status has been taken from both the explanation in the preamble as well as informal conversations with drafters of the regulations. It is anticipated that the final rules will be corrected to reflect this language.

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Pursuant to the proposed rules, if an FFI in such a jurisdiction qualifies as a limited FFI, the IRS will permit the other FFIs within its expanded affiliated group to become PFFI and/or DCFFIs. As currently drafted, the limited FFI within the group must agree to the account identification requirements as set forth in the FFI Agreement. Further, it must agree not to open any new U.S. or NPFFI accounts. Significantly, the rules provide that the limited FFI would be treated as a NPFFI for purposes of the penal withholding on reportable payments. Of further significance, the limited FFI relief is transitional and ends on December 31, 2015.

As mentioned, the limited FFI concept is incorporated into the rules to permit FFIs in an expanded affiliate group to become PFFIs or DCFFIs notwithstanding the fact that one of the group members operates in a jurisdiction which prohibits it from complying with certain terms of the FFI Agreement. The problem, however, is the fact that the relief is transitional. Even with the relaxation of certain FFI requirements, compliance with the FATCA regime will be both onerous and expensive. Under this transition relief, the FFIs in the group that have no legal prohibitions relating to full compliance will expend sizable resources, in terms of both time and money, developing systems and processes to satisfy the requirements of the FFI Agreement. However, as drafted, it is possible that at the end of 2015, if the limited FFI in the group cannot achieve the same level of compliance, all FFIs in that group are at risk of losing their PFFI or DCFFI status.

With respect to the limited FFI, there appear to be four possibilities: (1) a law change in the limited FFI's country of operation that would permit the limited FFI to achieve full compliance; (2) the limited FFI ceases operations in that country; (3) the ownership level of the limited FFI is reduced such that it is no longer included within the expanded affiliated group; or (4) the United States and the country in question enters into an intergovernmental agreement (discussed below).

It does not appear that any of the four possibilities is likely from a either a plausibility or timing perspective. That is, it is unlikely that the FFI can or will cease operations in the problematic country or take the drastic step of ownership restructuring solely for this purpose. Further, even if it were accepted that the country in which the limited FFI operated would be willing to change its laws to permit the limited FFI to achieve full FATCA compliance, (which would be needed for either 1 or 4, above), it is unrealistic that such a law change could be enacted and implemented within this short transitional time period. These issues leave many FFIs in an awkward planning position.

Certifications of "Responsible Officer"

With minor modifications, the proposed regulations follow the preliminary guidance requiring the PFFI's Responsible Officer to certify to the IRS that certain account identification procedures have been satisfied. Specifically, the PFFI's Responsible Officer must, within one year of the effective date of the FFI Agreement, certify that:

- The PFFI has completed the enhanced review for the accounts pre-existing accounts with a balance in excess of $1 million; and
- To the best of his/her knowledge, after conducting a reasonable inquiry, the PFFI did not have any formal or informal practices or procedures in place from August 6, 2011, through the date of the certification to assist account holders to avoid the chapter 4 rules (e.g., instructing them to split up accounts so they would fall within the de minimus thresholds).

In addition, within two years of the effective date of the FFI Agreement, the Responsible Officer must also certify that:

- The PFFI has completed the account identification and documentation requirements for

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all pre-existing accounts, or
- If the PFFI has not been able to obtain documentation for pre-existing accounts, when required, that the PFFI is following the terms of its FFI Agreement with respect to the treatment of such accounts

Verification of FFI's compliance with its FFI Agreement

Finally, proposed section 1.1471-4 provides rules related to verification of an FFI's compliance with its FFI Agreement.

While the proposed regulations provide that the FFI Agreement will not mandate external auditor reviews, as is currently required for QIs, it will require conduct periodic internal reviews of its compliance, and it will require the FFI's Responsible Officer to certify that the FFI has adequate policies and procedures in place, as well as certify the FFI's compliance with the FFI Agreement.

The IRS has requested comments regarding the scope and content of the periodic compliance testing. The FFI's Responsible Officer will then certify the level of compliance based on the results of such testing. When the compliance level is not acceptable to the IRS, the proposed regulations provide that the FFI Agreement will permit the IRS to mandate an external audit.

Section 1.1471-5 – section 1471 definitions

Section 1.1471-5 provides additional definitional terms that are applicable to the new regime. As anticipated, Treasury and the IRS broadened the scope of deemed compliant entities. They further bifurcated the group of DCFFIs into (1) those DCFFIs that must register with the IRS, obtain an FFI-EIN, and periodically certify that they continue to satisfy the requirements of deemed compliant status and (2) those that are permitted to self-certify their deemed compliant status to withholding agents without registering with the IRS. The list of both classes is set forth below:

Registered DC FFIs:

- Local FFIs
- Nonreporting Members of Participating FFI Groups
- Qualified Collective Investment Vehicles
- Restricted Funds

Certified DC FFIs:

- Non-registering Local Bank
- Retirement Funds
- Non-profit Organizations
- FFIs With Low-Dollar Accounts

Though not falling within either class, above, the final DCFFI is the Owner Documented FFI.

Also as anticipated, the section 1.1471-5 definition of "financial institution" would include most passive corporations. Specifically, a financial institution includes an entity that "is engaged primarily in the business of investing, reinvesting, or trading if the entity's gross income from such activities equals or exceeds 50 percent of the entity's gross income" during the relevant testing period.

Another fundamental point, as it relates to potential PFFIs, is the section 1.1471-5 definition of passthrough payment (withholdable payment and any foreign passthrough payment).

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The "foreign passthrough payment" component of this definition has been one of the most controversial aspects that Treasury and the IRS have had to address in the development of the FATCA regime. The proposed regulations reserve on this point and extend, until at least January 1, 2017, the imposition of chapter 4 withholding on such a payment. The problem, here, is identical to the one related to the limited FFI concept, above. Specifically, the fact that the FFI is required to enter into an FFI Agreement, the terms of which it may not be able to comply with in the future, puts it in a very precarious planning position.

Section 1.1471-6—Exempt beneficial owners

Section 1.1471-6 describes certain classes of beneficial owners that are exempt from FATCA's penal withholding. Such beneficial owners include:

- Foreign Governments
- International Organizations
- Foreign Central Banks of Issue
- Governments of U.S. Territories
- Certain Retirement Funds

With respect to retirement funds, the proposed rules provide that a retirement fund is an exempt beneficial owner when such fund is: (1) eligible for benefits pursuant to an income tax treaty between the United States and the fund's country of residence; (2) exempt from income tax in the country of residence; and (3) operates principally to administer or provide pension or retirement benefits. Thus, for example, a UK self-invested personal pension (SIPP) would qualify as an exempt beneficial owner under this proposed rule.

Section 1.1472-1—Withholding requirements on payments to certain NFFEs

Section 1.1472-1 of the proposed regulations provides the rules for withholding on certain NFFEs that fail to either certify that they have no substantial U.S. owners or fail to provide the names, addresses, and TINs of such substantial U.S. owners. The rules except from such withholding any payments made to publicly traded NFFEs, certain affiliated entities related to publically traded NFFEs, and NFFEs engaged in an active trade or business. With respect to the latter, the proposed regulations provide an income/asset test to determine whether the entity meets the requirements. For this purpose, an NFFE is considered to be an Active NFFE if less than 50% of its gross income for the preceding calendar year is passive income or less than 50% of its assets held during that same year are held for the production of passive income.

It is important to note that when making this determination, passive income includes "rents and royalties, other than rents and royalties derived in the active conduct of a trade or business conducted by the employees of the NFFE." Thus, for example, the royalties received by a foreign "loan-out" corporation which employs the foreign artist that created it, would be considered an active NFFE.

Finally, unlike the provisions in proposed section 1.1471-2 which provide transition relief for withholding on FDAP payments to NPFFIs (i.e., no withholding required prior to December 31, 2013), the provisions in section 1.1472-1 do not provide the same transitional relief. That is, there is no specified date for which withholding would be required. Thus, the statutory effective date, January 1, 2013, would prevail. Presumably, this is simply a drafting oversight and will be addressed in either a correction to the proposed regulations or in the final version of regulations.

Section 1.1473-1—Definitions

Proposed section 1.1473-1 provides additional definitions of chapter 4 terms. Significant, here, is the exclusion from the definition of withholdable payment for interest and original discount on certain short-term obligations as well as nonfinancial payments made in the ordinary course of the

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withholding agent's trade or business.

Consequently, pursuant to the proposed rules, most vendor-type payments made from the withholding agent's accounts payable department would not be subject to the new rules. (But see "Section 1.1471-3" above regarding possible future chapter 3 implications).

Section 1.1474-1—Withholding agent liability

Proposed section 1.1474-1 addresses a withholding agent's liability for chapter 4 tax, reporting requirements, procedures for over- and under-withholding adjustments, as well as procedures for claiming a chapter 4 refund.

With respect to reporting, the proposed rules anticipate that withholding agents will have a chapter 4 reporting obligation on all FDAP payments made. In addition, they must report any proceeds or foreign passthrough payments when withholding was required.* [The PFFI reporting provisions under proposed section 1.1471-4 make clear that a PFFI has a chapter 4 reporting obligation with respect to U.S. and recalcitrant accounts as well as payments to NPFFIs. As currently drafted, however, it is unclear how a PFFI would report to any other type of recipient.]

*Note, however, that a PFFI must report payments of non-U.S. source passive income made to NPFFIs. See the discussion under "Section 1.1471-4", above.

Alternative regime—Intergovernmental agreements

Finally, the preamble to the proposed regulations provides:

> *…that Treasury Department and the IRS are considering, in consultation with foreign governments, an alternative approach to implementation whereby an FFI could satisfy the reporting requirements of chapter 4 if: (1) the FFI collects the information required under chapter 4 and reports this information to its residence country government; and (2) the residence country government enters into an agreement to report this information annually to the IRS, as required by chapter 4, pursuant to an income tax treaty, tax information exchange agreement, or other agreement with the United States.*

While that language appears to indicate the alternative regime is limited to the reporting aspect of FATCA, it is interesting to note that, in connection with the release of the proposed regulations, Treasury released a joint statement of the United States, France, Germany, Italy, Spain, and the United Kingdom. In general, the statement provides that the above mentioned countries are exploring an intergovernmental approach to FATCA and describes, very generally, what this alternative regime might look like. For example, when a foreign country (called a "FATCA Partner") enters into an agreement with the United States, the FFIs in that country would not be:

- Subject to penal withholding on payments made to it by other withholding agents
- Required to impose withholding on passthrough payments made to other FFIs within the country (or in another country that is also a FATCA partner)
- Required to close an account held by a recalcitrant account holder or impose penal withholding on passthrough payments made to such account holders (presumably because the FFI would be reporting the account holder information to its local government who, in turn, would be providing it to the IRS)

The joint statement further provides that the United States would "commit to reciprocity with respect to collecting and reporting on an automatic basis to the authorities of the FATCA partner information of the U.S. accounts of residents of the FATCA partner."

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The obvious problem is the fact that U.S. financial institutions currently do not obtain or report to the IRS the level of information required by FATCA. Even if Treasury and the IRS finalize the much disputed bank deposit interest reporting regulations, this still would not rise to the level of like information. For example, if UK residents form an Italian corporation and open a U.S. deposit account, the U.S. financial institution would report the deposit interest paid to the Italian corporation to the IRS, which would exchange that information with Italy. The information relating to the corporation's shareholders, resident in the UK, would not be obtained, reported to the IRS, or available for exchange with the United Kingdom.

This leads to several questions:

- Do Treasury and the IRS intend to require U.S. financial institutions to implement account identification procedures similar to those set forth in section 1.1471-4 (relating to FFIs that enter into an FFI Agreement) so that the U.S. has "reciprocal" data to exchange?
- Or, instead, are they anticipating that the account identification rules for an FFI that operates within a country that is a FATCA partner would be much more limited?
- Further, and more significant at this point, is there a realistic possibility that an interested country could actually enter into an intergovernmental agreement prior to the date that the FFIs in its jurisdiction must beginning entering into FFI Agreements with the IRS (especially when a local law change may be required)?

Treasury and the IRS will need to provide answers to these questions in short order so that affected entities can squarely address what they can and should be doing to prepare.

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