

# Clients & Friends Memo

## IRS Notice 2010-60: Preliminary Guidance on the “FATCA” Reporting and Withholding Rules

September 3, 2010

### I. Introduction

On Friday, August 27, the Internal Revenue Service issued Notice 2010-60, which gives preliminary guidance on the foreign reporting and withholding regime, often referred to as “the FATCA regime” or simply “FATCA,” enacted in the Hiring Incentives to Restore Employment Act (the “HIRE Act”).<sup>1</sup>

### II. Background

Under FATCA, beginning in 2013, foreign investment banks, foreign commercial banks, foreign insurance companies, foreign hedge funds and private equity funds, foreign securitization vehicles, and other “foreign financial institutions” will be required to enter into an agreement with the Treasury Department that will require the foreign financial institution to obtain the name, address, taxpayer identification number and certain other information with respect to any direct or indirect United States “account holder” (which includes direct and indirect United States holders of non-publicly-traded equity or debt in the foreign financial institution) and report this information to the IRS or else be subject to a 30% U.S. withholding tax on certain U.S.-source income and the gross proceeds from the sale or disposition of property that produces this U.S.-source income. Any “recalcitrant” United States account holder that fails to provide the information will be subject to a 30% withholding tax on their share of any U.S.-source dividend, interest, rents, and certain other payments, and the proceeds of the sale of U.S. stocks and debt instruments. In the absence of regulations, any amounts withheld with respect to a foreign financial institution that is the beneficial owner of a payment will not be refundable or creditable unless the foreign financial institution is entitled to the benefits of a tax treaty with the United States.

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<sup>1</sup> Pub. L. 111-147 (H.R. 2847).

The foreign reporting and withholding regime provisions are often referred to as the “FATCA” provisions after the bill – the Foreign Account Tax Compliance Act of 2009 – in which they were originally introduced. FATCA was not enacted, but its reporting and withholding provisions were reintroduced in the HIRE Act, which became law on March 18, 2010. The HIRE Act (including the FATCA provisions) is discussed in our prior memo ([here](#)).

Beginning in 2013, certain other (non-financial) foreign entities will be required to obtain and disclose the name, address, and taxpayer identification number of any United States person that owns directly or indirectly 10% of the vote or value of any of its stock (for a corporation), 10% of its profits or capital (in the case of a partnership), 10% of the beneficial interests (for a trust), or any United States person that owns an equity interest in the foreign entity through a foreign investment or trading vehicle. If the non-financial foreign entity fails to disclose any of these United States persons, the foreign entity will be subject to a 30% withholding tax with respect to all U.S.-source dividend, interest, rents, and certain other payments, and 30% of the proceeds from the sale of any U.S. stock or debt securities.

Part III of this memorandum summarizes certain of the important aspects of the Notice and Part IV discusses the Notice in greater detail. Appendices to this memorandum contain flow charts that summarize the procedures and responsibilities that foreign and U.S. financial institutions will be required to follow in determining which of the foreign institution's accounts are owned by U.S. persons (each, a "U.S. account").

### III. Summary

- Grandfathered Obligations.

The Notice indicates that the Treasury Department and the IRS intend to issue regulations providing that any legal agreement that produces withholdable payments, is not treated as equity for federal income tax purposes, and has a definite expiration or term will be considered an "obligation" that, if outstanding on March 18, 2012, will be grandfathered (and thus, FATCA withholding will not apply to any future payment under the obligation). Thus, derivatives with a definitive expiration or term will be considered obligations for these purposes and, if they are outstanding on March 18, 2012, they will be grandfathered. However, instruments that constitute equity, or savings deposits, demand deposits, and other similar accounts without a definitive term will not be grandfathered. The Notice also indicates that brokerage, custodial, and similar agreements to hold financial assets for the account of others will not be grandfathered.

The Notice states that any "material modification" of an obligation that is outstanding on March 18, 2012, will cause the obligation to lose its grandfathered status. Existing Treasury regulations section 1.1001-3 will be used to determine whether a debt obligation has been materially modified; for all other obligations, all relevant facts and circumstances will determine whether the obligation has been materially modified.

- Safe Harbor From “Financial Institution” Status for Certain Entities.

As mentioned above, starting in 2013, withholding will be required on U.S.-source income paid to foreign financial institutions unless the foreign financial institution enters into an agreement with the Treasury Department. Under the Notice, (i) holding companies that do not have subsidiaries that are financial institutions, (ii) start-up companies that do not intend to start financial institutions, (iii) non-financial institution entities that are liquidating or reorganizing, (iv) insurance companies whose businesses consist solely of issuing insurance contracts without cash value, and (v) certain retirement plans will not be treated as “financial institutions,” and therefore will not be required to enter into an agreement with the Treasury Department. Additionally, the Notice indicates that the Treasury Department and the IRS do not intend to treat financial institutions organized in the U.S. territories as foreign financial institutions.

- Procedures and Responsibilities that Foreign Financial Institutions Will Be Required to Follow in Determining Which of Their Accounts Are U.S. Accounts.

As mentioned above, starting in 2013, foreign financial institutions will be required (pursuant to their agreements with the Treasury Department) to provide the IRS with information with respect to their U.S. accounts. The Notice describes the steps that foreign financial institutions will be required to follow in determining which of their accounts are U.S. accounts. Appendices to this memorandum illustrate these steps.

#### **IV. Discussion**

##### **A. Grandfathered Obligations**

The Notice indicates that the Treasury Department and the IRS intend to issue regulations that will provide that any legal agreement that produces withholdable payments (except for agreements that constitute equity for federal income tax purposes or do not contain a definitive expiration or term) will be considered an “obligation” and, if outstanding on March 18, 2012, will be grandfathered (and FATCA withholding will not apply to any future payment under the obligation). Thus, derivatives with a definitive expiration or term will be considered obligations for these purposes and, if they are outstanding on March 18, 2012 they will be grandfathered. However, instruments that constitute equity or otherwise do not have a definitive term, such savings deposits, demand deposits, and other similar accounts will not be grandfathered. The Notice also indicates that brokerage, custodial, and similar agreements to hold financial assets for the account of others will not be grandfathered.

Under the Notice, any “material modification” of an obligation that is outstanding on March 18, 2012 will cause the obligation to lose its grandfathered status. Existing regulations section 1.1001-3 will be used to determine whether a debt obligation has been materially modified; for all

other obligations, all relevant facts and circumstances will determine whether the obligation has been materially modified.

### **B. Definition of “Foreign Financial Institution”**

The FATCA provisions impose a 30% withholding tax on U.S.-source interest, dividends, rents, and other “fixed or determinable, annual or periodical” income, and the gross proceeds from the sale or other disposition of any property that produces U.S.-source interest or dividends (e.g., stock or debt of a U.S. corporation), paid to a “foreign financial institution,” unless the foreign financial institution enters into an agreement with the Treasury Department to provide certain information with respect to (1) United States persons that hold depositary and custodial accounts at the institution and (2) equity and debt of the foreign financial institution (other than equity or debt that is regularly traded on an established securities market).<sup>2</sup> The Notice clarifies the definition of a financial institution.<sup>3</sup>

Under the Notice, financial institutions will be defined to include entities that accept deposits in the ordinary course of a banking or similar business, which generally includes savings banks, commercial banks, savings and loan associations, thrifts, credit unions, building societies, and other cooperative banking institutions.<sup>4</sup>

In addition, under the Notice, entities that hold financial assets for the account of others as a substantial portion of their business, such as broker-dealers, clearing organizations, trust

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<sup>2</sup> No withholding is imposed on payments to a foreign financial institution that fails to enter into an agreement with the Treasury Department if the beneficial owner of the payment is (i) a foreign government, political subdivision of a foreign government, or any wholly owned agency or instrumentality of either of the foregoing, (ii) an international organization or its wholly owned agency or instrumentality, (iii) a foreign central bank of issue, or (iv) any other class of persons that the IRS identifies as posing a low risk of tax evasion.

<sup>3</sup> Under section 1471(d)(5), a foreign financial institution is defined broadly to include any foreign entity that (i) accepts deposits in the ordinary course of a banking or similar business, (ii) holds financial assets for the account of others as a substantial portion of its business, or (iii) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting, or trading in financial assets (including securities, partnership interests, commodities, or any interest in such securities, partnership interests, or commodities). The Notice provides guidance on this statutory definition.

All references to section numbers are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.

<sup>4</sup> However, under the Notice, the fact that an entity is subject to the banking and credit laws of the United States, a state, a political subdivision thereof, or a foreign country, or to supervision and examination by agencies having regulatory oversight of banking or similar institutions, is relevant but is not necessarily determinative as to whether an entity is a financial institution.

companies, custodial banks, and entities acting as custodians with respect to the assets of employee benefit plans, will be treated as financial institutions.<sup>5</sup>

Finally, under the Notice, financial institutions will include entities that are engaged primarily in the “business” of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest (including a futures or forward contract or an option) in these securities, partnership interests, or commodities. Securities for these purposes will include stock; interests in publicly-traded partnerships, debt, swaps, and many derivatives; actively-traded commodities, commodity swaps, and other derivatives referencing commodity prices.<sup>6</sup>

The Notice indicates that a “business” for FATCA purposes is much broader than generally for federal income tax purposes. Thus, foreign hedge funds that are “investors” in securities or commodities are likely to be treated as engaged in a business for FATCA purposes and therefore may constitute foreign financial institutions. Indeed, even catastrophe bond issuers (which often enter into only a single transaction) may be treated as engaged in a business (and therefore a foreign financial institution) for these purposes (unless it qualifies as an insurance company and is excluded from the definition of financial institution, as discussed immediately below).<sup>7</sup>

### **C. Entities Excluded from the Definition of a Financial Institution or Otherwise Exempt from Some or All of the Reporting Requirements**

The Notice indicates that future regulations will exclude from the definition of a financial institution (and therefore from withholding under FATCA) the following entities, so long as the entities do not accept deposits or act as custodians:

- Holding companies that are not investment funds and that hold only subsidiaries that are not financial institutions.
- Start-up companies that intend to start non-financial institution businesses. However, this exclusion will expire after the first 24 months of the entity’s organization.

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<sup>5</sup> As in the case of deposit-taking institutions, the fact that an entity is subject to the banking and credit laws or broker-dealer regulations of the United States, a state, a political subdivision thereof, or a foreign country, or to supervision and examination by agencies having regulatory oversight of banking or similar institutions, is relevant, but is not necessarily determinative as to whether that entity is a financial institution.

<sup>6</sup> More specifically, “security” is defined by reference to section 475(c)(2) without the exclusions for section 1256 contracts, which are, generally, regulated futures contracts, foreign currency derivatives, listed options that do not reference individual equities or certain equity indices. “Commodity” is defined by reference to section 475(c)(2).

<sup>7</sup> A catastrophe bond issuer is a special purpose vehicle that enters into a reinsurance contract or derivative under which it assumes the risk of a natural catastrophe. This risk, in turn, is borne by the vehicle’s noteholders.

- Non-financial entities that are liquidating or in the process of reorganizing pursuant to a bankruptcy.
- Hedging or financing entities that service only a non-financial “expanded affiliated group”<sup>8</sup> that does not include any financial institutions.
- Insurance companies that issue insurance or reinsurance contracts without cash value, such as most property and casualty insurance companies, reinsurance companies, and life insurance companies that issue only term life insurance contracts.
- Retirement plans that (i) qualify as retirement plans under the law of the country in which established, (ii) are sponsored by a foreign employer, and (iii) do not allow U.S. participants or beneficiaries other than, generally, employees that work for the foreign employer in the country in which the retirement plan is established.

In addition, the Notice indicates that investment funds and other entities that have only a small number of direct or indirect account holders – such as a small family trust settled and funded by a single person for the sole benefit of his or her children – will be subject to less burdensome reporting requirements than FATCA generally requires.

The Notice also provides that a financial institution organized under the laws of a U.S. territory will generally not be treated as a foreign financial institution. It is unclear whether this rule would exempt a partnership that is organized in a U.S. territory and elects to be treated as a foreign corporation for U.S. federal tax purposes. Financial institutions organized in U.S. territories are, however, “withholding agents” under the FATCA rules,<sup>9</sup> which means that they will generally be required to withhold on payments to foreign entities that have not entered into an agreement with the Treasury Department.

#### **D. Treatment of U.S. Branches of Foreign Financial Institutions and Controlled Foreign Corporations**

The Notice provides that U.S. branches of foreign financial institutions will not be exempt from the requirement to enter into an agreement with the Treasury Department.<sup>10</sup> However, the Treasury Department and the IRS are considering permitting U.S. branches of foreign financial institutions that receive payments as intermediaries to report their account holders under the methods applicable to U.S. financial institutions (as illustrated in Appendix D). These rules are expected to

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<sup>8</sup> An expanded affiliated group is, very generally, a group of entities owned by 50% common control (by vote or value).

<sup>9</sup> Section 1473(4).

<sup>10</sup> Payments received by a U.S. branch for its own account and that are effectively connected with a U.S. trade or business are excluded under the statute from FATCA withholding.

be administratively less burdensome than reporting under the methods that will be imposed on foreign financial institutions generally.

Additionally, the Notice confirms that controlled foreign corporations (“CFCs”) will not be exempt from the FATCA rules by reason of being CFCs.

#### **E. Requirements for Foreign Financial Institutions that Enter into Agreements with the Treasury Department**

The Notice provides that foreign financial institutions that enter into agreements with the Treasury Department will be permitted to rely on IRS Forms W-9 that they have already collected for other U.S. tax purposes, and will be required to request IRS Forms W-8BEN and W-9 from certain of their United States account holders (determined under the procedures illustrated in the appendices) only in limited circumstances. The Notice indicates that foreign financial institutions that enter into an agreement with the Treasury Department will also be required to collect Form W-8BEN from certain of their account holders and identify other foreign financial institutions as “participating foreign financial institutions” (i.e., foreign financial institutions that have entered into an agreement with the Treasury Department), “deemed-compliant foreign financial institutions,” non-participating foreign financial institutions (i.e., foreign financial institutions that have not entered into an agreement with the Treasury Department), or entities described in section 1471(f).<sup>11</sup> To facilitate this process, the IRS intends to issue special employer identification numbers to foreign financial institutions that have entered into agreements with the Treasury Department that identify them as participating financial institutions. Until withholding agents are able to verify the status of foreign financial institutions with the IRS, withholding agents and participating foreign financial institutions will be permitted to rely on a certification provided by a foreign financial institution to the effect that it has entered into an agreement with the Treasury Department, unless the withholding agent or foreign financial institution knows or has reason to know that the certification provided is incorrect.

#### **F. Reporting of U.S. Accounts**

The IRS is developing a new form for reporting the information required by the FATCA rules. This form will be filed electronically. The Treasury Department and the IRS also intend to issue guidance coordinating the FATCA reporting provisions with other U.S. tax reporting obligations.

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<sup>11</sup> More specifically, deemed-compliant foreign financial institutions are foreign financial institutions that, under future regulations, are deemed compliant with the FATCA reporting requirements because they either (i) comply with the procedures that the IRS prescribes to ensure that the institution does not maintain U.S. accounts and meets such other requirements that the IRS prescribes with respect to accounts of other foreign financial institutions maintained at the institution or (ii) are members of a class of institutions that are exempt from withholding under the FATCA rules, such as the entities listed in Part IV.C. above. Entities described in section 1471(f) include foreign governments and foreign central banks, which are exempt from withholding under the FATCA rules.

In addition, the Treasury Department and the IRS intend to issue regulations providing that, in the case of a participating foreign financial institution that maintains an account of another participating foreign financial institution, only the participating foreign financial institution that has the more direct relationship with the investor or customer will be required to report the information required under FATCA.<sup>12</sup>

Further, the Notice indicates that the Treasury Department and the IRS intend to require a participating foreign financial institution to report the number and aggregate value of financial accounts held by recalcitrant account holders, including those that have indicia of U.S. ownership.<sup>13</sup> The Treasury Department and the IRS request comments on punitive measures that should be taken to address long-term recalcitrant accounts.

Finally, the Notice indicates that the Treasury Department and the IRS intend to issue regulations that would require all or most financial institutions to electronically file their returns with respect to any FATCA tax for which such institutions are liable, beginning with returns filed for taxable years ending after December 31, 2012.

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If you have any questions regarding this memorandum, please contact any member of the Cadwalader Tax Department.

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<sup>12</sup> The Notice provides that, for example, if a participating foreign financial institution issues shares that are held by another participating foreign financial institution on behalf of a U.S. person, the shares owned by the U.S. person would (absent an applicable exception) constitute a financial account maintained by the first financial institution and the U.S. person's custodial account maintained by the second financial institution would also be a financial account. The Notice indicates that only the financial institution that holds the shares (i.e., the custodian) will be required to report to the IRS.

<sup>13</sup> Indicia of potential U.S. ownership include (i) identification of any account holder as a U.S. resident or citizen; (ii) a U.S. address associated with a holder of the account; (iii) a U.S. place of birth for a holder of the account; (iv) a U.S. "in care of" address, a "hold mail" address, or a P.O. box address that is the sole address on file with respect to the account holder; (v) power of attorney or signatory authority granted to a person with a U.S. address; or (vi) standing instructions to transfer funds to an account maintained in the U.S. or directions received from a U.S. address.