The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 25140

April 26, 2011

IRS Issues Supplemental Notice on FATCA

[25140]

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TO: INTERNATIONAL OPERATIONS ADVISORY COMMITTEE No. 6-11 RE: IRS ISSUES SUPPLEMENTAL NOTICE ON FATCA

The Internal Revenue Service has issued the attached notice (Notice 2011-34, or the "Supplemental Notice") supplementing the notice (Notice 2010-60, or the "Initial Notice") issued last August regarding the so-called "FATCA" information reporting and withholding provisions under Chapter 4 of the Internal Revenue Code ("Code"). [1] These "Chapter 4" reporting and withholding provisions apply generally to payments made after December 31, 2012.

The areas addressed by the Supplemental Notice are: (1) identifying U.S. individual accounts among a foreign financial institution's ("FFI's") preexisting accounts; (2) "passthru payments;" (3) "deemed compliant" FFIs; (4) reporting on U.S. accounts; (5) qualified intermediaries ("QIs"); (6) expanded affiliated groups of FFIs; and (7) the effective date of FFI Agreements. This memorandum describes issues of particular interest to funds and other collective investment vehicles.

Procedures for Identifying U.S. Accounts among Preexisting Accounts

The Supplemental Notice revises in several important respects the procedures for reviewing preexisting individual accounts to identify those belonging to U.S. persons. New procedures are provided, among other things, for "private banking accounts" maintained or serviced (1) by an FFI's "private banking department" or (2) as part of a "private banking relationship."

The procedures to be followed by participating FFIs in determining whether preexisting individual accounts are U.S. accounts, recalcitrant accounts, or non-U.S. accounts are described in detail in the Supplemental Notice. Among the respects in which the procedures

have been revised are the following:

- An account already documented as the account of a U.S. person for other U.S. tax purposes will not be treated as a U.S. account for FATCA purposes if: (1) the account is a depository account; (2) each holder of the account is a natural person; and (3) the balance or value of such account as of the end of the calendar year (rather than based upon the average of the month-end values for the year) preceding the effective date of the FFI's FFI Agreement is $50,000 or less (or the foreign currency equivalent) (Step 1).
- Any account with a balance or value of $50,000 or less as of the end of the calendar year preceding the effective date of the FFI's FFI Agreement may be treated by the FFI as a non-U.S. account (Step 2).
- New and detailed procedures (resembling the Initial Notice's procedures for all preexisting individual accounts) are provided for identifying U.S. accounts of private banking departments and U.S. accounts that are maintained or serviced as part of a private banking relationship (Step 3).
- FFIs must determine whether electronically searchable information that it maintains, and that is associated with account holders or accounts that are not identified as U.S. accounts under Step 1, non-U.S. accounts under Step 2, or private banking accounts under Step 3, includes certain specified indicia of U.S. ownership (Step 4).
- Information treated as "electronically searchable" includes only information maintained by the FFI 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 may be used (thus excluding, among other things, .pdf files and scanned documents).
- Procedures are provided for requesting additional documentation if an account is identified through an electronic search as containing U.S. indicia.
- Specified diligent review procedures are provided for "high value accounts" with a balance or value of $500,000 or more at the end of the year preceding the effective date of the FFI's FFI Agreement. The Supplemental Notice thus effectively eliminates the Initial Notice's requirement that an FFI make determinations, within five years after the date on which the FFI's FFI Agreement takes effect, regarding all preexisting accounts (Step 5).
- Annual retesting is required beginning in the third year following the effective date of the FFI Agreement to determine whether preexisting accounts that previously did not meet the "high value account" threshold would do so if the account balance or value were tested on the last day of the preceding year (Step 6).

The FFI's chief compliance officer or another equivalent-level officer must certify to the IRS, among other things, (1) when the FFI has completed the procedures, other than the annual retesting, for identifying U.S. accounts, and (2) that the FFI had written procedures in place as of the effective date of the FFI's FFI Agreement to prohibit its employees from advising U.S. account holders on how to avoid having their U.S. accounts identified.

Passthru Payments

The Supplemental Notice provides the first published IRS guidance regarding passthru payments. An FFI's payment will be treated as a passthru payment to the extent of (1) the amount of the payment that is a withholdable payment [2] plus (2) the amount of the payment that is not a withholdable payment multiplied by (A) the passthru payment percentage of the entity that issued the interest or instrument (in the case of a custodial payment), or (B) the payor FFI's passthru payment percentage (in the case of any other payment).

An FFI's passthru payment percentage is determined for each quarterly testing date. The percentage is calculated by dividing the sum of the FFI's U.S. assets on each of the last four quarterly testing dates by the sum of its total assets on those four dates. A transition method is available for determining the passthru payment percentage in the first year of an FFI Agreement. Quarters are determined in accordance with the FFI's fiscal year; the quarterly testing date will be either the last redemption date of the quarter (for entities that conduct redemptions at least quarterly) or the last business day of the quarter (for all other entities). The Supplemental Notice requests comments on whether alternative methods for determining passthru payment percentages may be appropriate and administrable.

In defining a U.S. asset for purposes of the passthru payment percentage, the Supplemental Notice provides that a debt or equity interest in a domestic corporation will be treated solely as a U.S. asset; conversely, a debt or equity interest in a foreign corporation will be treated solely as a non-U.S. asset. This treatment will apply regardless of whether the interest otherwise would be an asset of a type that could give rise to a passthru payment.

The following rules and presumptions apply for determining an FFI's passthru payment percentage. An FFI that does not calculate and publish its passthru payment percentage will be deemed to have a passthru payment percentage of 100 percent. An FFI may rely on a passthru payment percentage of a lower-tier FFI that is a participating or deemed-complaint FFI so long as the FFI publishes its passthru percentage pursuant to rules described below. An FFI that is not a participating or deemed-compliant FFI will be presumed to have a passthru payment percentage of zero. [3] The IRS intends to maintain a database that FFIs may check to confirm whether an FFI is participating or deemed compliant. An upper-tier FFI will be required to confirm that a lower-tier FFI is not a participating or deemed-compliant FFI before presuming that the lower-tier FFI's passthru payment percentage is zero. The Supplemental Notice requests comments regarding this approach for defining a U.S. asset.

A participating FFI will be required to make available its passthru payment percentage for a testing date within three months after that date. This information must be made available on a website or database that is readily searchable by the public. The Supplemental Notice requests comments on the most efficient mechanism for ensuring that accurate passthru payment percentage information is readily available to FFIs so that the FFIs may meet their Chapter 4 obligations. Future guidance will set forth rules for determining when a passthru payment percentage is out of date and how frequently an FFI must check for more recently published passthru payment percentages.

The Supplemental Notice also provides guidance regarding custodial payments. A custodial payment is defined as a payment with respect to which an FFI acts as a custodian, broker,

nominee, or otherwise as an agent for another person. If a custodial payment is made with respect to an interest (such as fund shares) issued by another FFI (an “issuer FFI”), the portion of the custodial payment that is a passthru payment is equal to the issuer FFI’s passthru payment percentage.

Grandfathered obligations (that give rise to payments exempt from Chapter 4) will not be treated as U.S. assets in determining an entity’s passthru payment percentage. A grandfathered obligation also will not give rise to a passthru payment under the custodial payment rules.

The Supplemental Notice requests comments regarding possible exemptions from the passthru payment definition that would, to the extent possible, be consistent with the policy goals of the passthru payment rules and reasonable in light of the potential burden on participating FFIs.

“Deemed Compliant” Foreign Financial Institutions

An FFI may be deemed compliant if it: (1) applies with the IRS for deemed-compliant status; (2) obtains from the IRS an FFI identification number (an “FFI-EIN”) identifying it as a deemed-compliant FFI; and (3) certifies to the IRS every three years that it satisfies the requirements for deemed-compliant status.

The Supplemental Notice describes situations in which each FFI in an expanded affiliated group of banks – where each bank is organized in the same country and maintains operations only within that country – will be treated as a deemed-compliant FFI. Among other things, these FFIs cannot solicit account holders outside the country of organization and must implement policies and procedures to ensure that they do not open or maintain accounts for non-residents, non-participating FFIs, or non-financial foreign entities (“NFFEs”) other than excepted NFFEs organized and operating in the country in which the expanded affiliated group’s members are organized.

Guidance also will be issued under which any FFI that is a member of an expanded affiliated group that includes one participating FFI (an “FFI member” of a “Participating FFI Group”) may be treated as deemed compliant. To qualify for this status: (1) the FFI member must maintain operations only within its country of organization; (2) the FFI member must not solicit account holders outside its country of organization; (3) the FFI member must implement the preexisting and customer identification procedures required of participating FFIs to identify U.S. accounts, non-participating FFI accounts, and NFFE accounts (other than accounts of excepted NFFEs organized and operating in the country in which the FFI member maintains the account); and (4) the FFI must agree that, if a U.S. account, non-participating FFI account, or NFFE account described above is found, the FFI either will (a) enter into an FFI Agreement, (b) transfer the account(s) to an affiliate that is a participating FFI, or (c) close the account. Among other things, the Supplemental Notice requests comments regarding other policies and procedures that could apply to ensure that an FFI member of a participating FFI Group identifies any U.S. accounts that it opens or maintains.

Collective investment vehicles and other investment funds will be treated as deemed compliant, pursuant to the Supplemental Notice, so long as three requirements are met. Specifically: (1) all holders of record of direct interests in the fund must be either (a) participating FFIs or deemed-compliant FFIs holding on behalf of other investors, or (b) entities, such a foreign governments or persons posing a low risk of tax evasion, described in Code section 1471(f); (2) the fund must prohibit the acquisition of fund shares by any

person that is not a participating FFI, a deemed-compliant FFI, or a Code section 1471(f) entity; and (3) the fund must certify that it will calculate and publish its passthru payment percentages under the regulations.

The Supplemental Notice states that the Treasury Department and the IRS will continue to consider comments regarding whether any category of funds may be treated as deemed compliant because: (1) all direct holders in the fund are participating FFIs, U.S. Financial Institutions ("USFIs"), deemed-compliant FFIs, Code section 1471(f) entities, or non-participating FFIs acting as distributors; (2) distribution or similar agreements prohibit sales of fund shares to specified U.S. persons, NFFEs other than excepted NFFEs, and non-participating FFIs holding for their own account; (3) each distributor agrees to enforce the sales prohibitions; and (4) the fund satisfies other requirements and meets other criteria relevant to Chapter 4's purposes.

Additional guidance will be issued providing that a deemed-compliant FFI may use an agent to perform the necessary due diligence and take any action required to maintain the FFI's deemed compliant status. Similarly, a participating FFI may use an agent to perform its obligations under its FFI Agreement. In all cases, the deemed-compliant or participating FFI will remain responsible for ensuring satisfaction of all relevant requirements.

The Supplemental Notice provides further that the Treasury Department and the IRS continue to consider comments regarding the types of foreign retirement plans that should be treated as posing a low risk of tax evasion under Code section 1471(f). Guidance also is contemplated regarding foreign retirement plans or retirement accounts that may be deemed compliant.

Finally, the Treasury Department and the IRS are considering other categories of entities that should be treated as deemed compliant. These entities would be ones that possess characteristics, or have appropriate policies and procedures in place, consistent with the purpose of the passthru payment rule to prevent them from being used by non-participating FFIs to avoid Chapter 4 reporting and withholding.

Reporting Obligations with Respect to U.S. Accounts

The Supplemental Notice modifies certain FFI reporting requirements announced in the Initial Notice. The detailed requirements for reporting each year the highest monthly account balance for an account are replaced with a requirement to report year-end account balances. Similarly, the Initial Notice's requirement to report gross receipts and gross withdrawals and payments made to and from U.S. accounts is replaced with a requirement to report separately (1) the gross amount of (a) dividends, (b) interest, and (c) other income, and (2) the gross proceeds from the sale or redemption of property, that is paid or credited each year to the account.

Importantly, these amounts and the character thereof need not be determined in accordance with U.S. tax laws, so long as the amounts and character are determined under the same principles that the FFI uses to report information on its resident account holders to the jurisdiction in which the FFI is located. To the extent that these amounts are not reported to the local tax authorities, such amounts must be determined in the same manner as is used for reporting to account holders. If amounts are reported neither to local tax authorities nor to investors, such amounts must be reported using U.S. tax principles or any reasonable method consistent with the FFI's general accounting principles.

The Supplemental Notice provides further that in the case of an equity or debt interest in an FFI, other than an interest regularly traded on an established securities market (i.e., an interest described in Code section 1471(d)(2)(C)), the FFI will be required to report with respect to such equity or debt interest held in a U.S. account the gross amount of (1) all distributions, interest, and similar amounts credited during the year, and (2) each redemption payment made during the year.

If a U.S. account is closed or transferred in its entirety by an account holder during the year, the FFI must report the income paid or credited to the account through the date of transfer/closure and the amount withdrawn or transferred. The FFI also will be required to report that the U.S. account has been closed or transferred.

Any statements sent to account holders of U.S. accounts in the ordinary course of business must be retained by the FFI for five years pursuant to the Supplemental Notice and provided to the IRS upon request.

Any FFI that elects to report as if it were a U.S. payor will not be required to report cost basis under the new cost basis reporting requirements of Code section 6045(g).

The Supplemental Notice also addresses reporting by branches and affiliates. Draft FFI Agreements will require FFIs to identify the branch that maintains any U.S. account being reported. FFIs will be permitted to elect to have each branch report separately information regarding U.S. accounts it maintains (such as where local law prohibits the consolidation of information across branches or affiliates located in different jurisdictions).

Qualified Intermediaries

The Treasury Department and the IRS intend to require all FFIs acting as qualified intermediaries (“QIs”), for purposes of so-called “Chapter 3” reporting and withholding, to agree to become participating FFIs as of January 1, 2013, unless they qualify as deemed-compliant FFIs. Transition rules will be provided under both Chapter 3 and Chapter 4 to accommodate this change.

Expanded Affiliated Groups of FFIs

The Supplemental Notice provides that each affiliate in an FFI Group must be a participating FFI or a deemed-compliant FFI. An “affiliated” group, for these purposes, generally is defined as any group of entities with more than 50 percent common ownership. Each affiliate in the FFI Group that is a participating FFI will be required to execute an FFI Agreement that applies to all of its worldwide branches and offices; each such FFI will be issued its own FFI-EIN number. Consideration will be given to circumstances in which one or more non-participating FFI affiliates may be part of an FFI Group.

A coordinated application process will be provided so that all FFI affiliates of an FFI Group will apply together for participating FFI or deemed-compliant status. Each FFI Group will be required to designate a “lead FFI,” which will be required to complete an application and execute participating FFI Agreements or deemed-compliant FFI status certifications on behalf of each FFI affiliate. The lead FFI also will serve as the IRS’ central contact point unless the lead FFI designates other affiliates for specific purposes.

The Treasury Department and the IRS also intend to permit FFI Groups to allow a designated FFI to be appointed by some or all of the affiliated FFIs to become a

“Compliance FFI” and assume an oversight role with respect to the Group’s compliance with the Chapter 4 requirements. Comments regarding this Compliance FFI structure are requested by the Supplemental Notice.

Finally, the Treasury Department and the IRS are considering whether a centralized compliance option should be provided for funds and other collective investment vehicles that are associated with a common asset manager or other agent. Under this approach, the asset manager or other agent would execute a single FFI Agreement on behalf of each member of the group of funds that contracts with the asset manager or agent to perform the functions required under the FFI Agreement with respect to the fund.

Effective Date of FFI Agreements

FFI Agreements will be effective, pursuant to the Supplemental Notice, on the later of the date they are executed or the effective date of the provisions by which FATCA was enacted (January 1, 2013).

Deadline for Written Comments

Comments on the Supplemental Notice are to be filed by June 7, 2011.

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Attachment

endnotes

[1] See Institute Memorandum (24517) to Tax Members No. 27-10 and International Members No. 18-10, dated August 30, 2010. The Chapter 4 withholding regime was enacted in March 2010 as part of the Hiring Incentives to Restore Employment (“HIRE”) Act. See Institute Memorandum (24186) to Tax Members No. 7-10 and International Members No. 5-10, dated March 17, 2010. FATCA is the acronym for “Foreign Account Tax Compliance Act,” which was an earlier version of the Chapter 4 withholding regime enacted as part of the HIRE Act.

[2] A withholdable payment is defined generally under FATCA to include any payment of income from U.S. sources and any gross proceeds from the disposition of property that can produce interest or dividends from U.S. sources. See Code section 1473(1)(A).

[3]; The passthru payment percentage for a nonparticipating FFI appears to be zero because 30 percent FATCA withholding already would have been imposed on any U.S.-source income and/or proceeds paid to the nonparticipating FFI.
