

ClientAlert

Tax

September 2010

IRS Issues Preliminary Guidance on New FATCA Withholding Tax Regime

I. Introduction

On August 27, 2010, in Notice 2010-60 (the "Notice"), the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "Service") issued preliminary guidance pertaining to the new US withholding regime and information reporting requirements for certain accounts maintained by foreign institutions, commonly referred to as the Foreign Account Compliance Act provisions (the "FATCA provisions"), that were enacted as part of the Hiring Incentives to Restore Employment Act (the "HIRE Act") on March 18, 2010. The Notice constitutes preliminary guidance as to the positions that Treasury and the Service may take when future Treasury Regulations are issued. Treasury and the Service have requested comments on the issues addressed in the Notice and intend to issue regulations prior to December 31, 2012 (the effective date of the new rules discussed below).

For a general overview of the FATCA provisions, please see our [March 2010 Client Alert](#). This Alert provides a brief summary of preliminary guidance issued in the Notice, including preliminary guidance with respect to (i) "obligations" that are treated as exempt from FATCA withholding under the so-called grandfather provision, (ii) the definition of "financial institution," (iii) the procedures that financial institutions may be required to follow to collect information and identify persons with respect to US accounts and (iv) the manner and type of information that a foreign financial institution ("FFI") must report with respect to its US accounts pursuant to agreements with the Service under the FATCA provisions.

II. The Grandfather Provision and the Definition of the Term "Obligation"

Under the FATCA provisions, no amounts are required to be deducted or withheld from any payment under any "obligation" outstanding on March 18, 2012, or from the gross proceeds from any disposition of such an obligation. The Notice provides that the term "obligation" will mean any legal agreement that produces or could produce "withholdable payments," excluding brokerage, custodial and similar agreements to hold financial assets for the account of others and to make and receive payments of income and other amounts with respect to such assets. The term "obligation" will not include any instrument treated as equity for US tax purposes, or any legal agreement that lacks a definitive expiration or term



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Should you have any comments or questions, please contact, at your convenience:

Ray Simon
Partner
+ 1 212 819 8857
rsimon@whitecase.com

John Lillis
Partner
+ 1 212 819 8512
jlillis@whitecase.com

Jeremy Naylor
Partner
+1 212 819 8760
jnaylor@whitecase.com

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
United States
+ 1 212 819 8200

(e.g., savings deposits, demand deposits and other similar accounts). In general, the Internal Revenue Code of 1986, as amended (the "Code") defines "withholdable payments" to include (i) payments of US source fixed or determinable annual or periodical gains, profits and income ("FDAP-type income") and (ii) any gross proceeds from the sale or other disposition of any property of a type which can produce interest or dividends from US sources. The term withholdable payment generally includes interest on deposits with foreign branches of a domestic commercial bank (which is otherwise non-US source income) and does not include effectively connected income.

Furthermore, the Notice provides that an obligation entered into on or before March 18, 2012 will be treated as outstanding on March 18, 2012 and that any material modification of an obligation after March 18, 2012 will result in the obligation being treated as newly issued as of the effective date of such modification. For any obligation that constitutes indebtedness for US tax purposes, a material modification will mean any significant modification of the debt instrument as defined in Treasury Regulation Section 1.1001-3. In all other cases, whether a modification of an obligation is material will be determined based on the facts and circumstances of the particular case.

III. The Scope of the Term "Financial Institution"

In general, the FATCA provisions impose a 30 percent withholding tax on any withholdable payment that is made to a foreign financial institution that fails to enter into an agreement with the Secretary of the Treasury (the "Secretary") under which it agrees to undertake certain due diligence, reporting and withholding responsibilities. The Code defines a "financial institution" as any entity that (1) accepts deposits in the ordinary course of a banking or similar business, (2) holds financial assets for the account of others as a substantial portion of its business or (3) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities or any interest in such securities, partnership interests or commodities. The Notice provides preliminary guidance on the three categories of financial institutions described above:

- Category 1 financial institutions generally include, but are not limited to, banks, savings banks, commercial banks, savings and loan associations, thrifts, credit unions, building societies and other cooperative banking institutions.
- Category 2 financial institutions include, for example, broker-dealers, clearing organizations, trust companies, custodial banks and entities acting as custodians with respect to the assets of employee benefit plans.

- Category 3 financial institutions include, but are not limited to, mutual funds (or their foreign equivalent), funds of funds (and other similar investments), exchange-traded funds, hedge funds, private equity and venture capital funds, other managed funds, commodity pools and other investment vehicles.

Furthermore, the Code provides that withholding under the FATCA provisions shall not apply to any payment to the extent that the beneficial owner of such payment is (i) any foreign government, any political subdivision of a foreign government, or any wholly owned agency or instrumentality of any one or more of the foregoing, (ii) any international organization or any wholly owned agency or instrumentality thereof or (iii) any foreign central bank of issue. The Notice provides preliminary guidance as to which entities the Service intends to exclude from the definition of "financial institution." Subject to certain exceptions, the Service intends that an entity that otherwise would be treated as a financial institution because it is primarily engaged in investing, reinvesting or trading in securities will not be treated as a financial institution if such entity: (i) primarily acts as a holding company for subsidiaries that engage in a trade or business other than that of a financial institution; (ii) is a foreign start-up entity that is investing capital into assets with the intent to operate a nonfinancial institution business; (iii) is in the process of liquidating its assets or reorganizing with the intent to continue or recommence operations as a nonfinancial institution; or (iv) primarily engages in financing and hedging transactions with or for members of its expanded affiliated group that are not FFIs and does not provide such services to nonaffiliates. The Service intends that payments beneficially owned by these entities are exempt from withholding under the FATCA provisions, although certain documentation and reporting requirements may apply to such entities that are excluded from the definition of "financial institution."

In addition, the Service intends to provide favorable treatment under the FATCA provisions for certain entities. First, entities whose business consists solely of issuing insurance or reinsurance contracts without cash value (e.g., property and casualty insurance contracts, reinsurance contracts or term-life insurance contracts) will be treated as nonfinancial institutions. Second, payments beneficially owned by certain foreign retirement plans will be exempt from withholding imposed on FFIs. Such foreign retirement plans will include those that (i) qualify as retirement plans under the law of the country in which they are established, (ii) are sponsored by a foreign employer and (iii) do not allow US participants or beneficiaries other than employees that worked for the foreign employer in the country in which such retirement plan is established during the period in which benefits accrued. Finally, certain investment funds and entities consisting of only a small number of account holders who are individuals or certain nonfinancial foreign entities that are

exempt from withholding or reporting under the FATCA provisions will be treated as deemed-compliant FFIs, provided that certain requirements are satisfied.

IV. Procedures for the Collection of Information and Identification of Persons by Financial Institutions

A. Reliance on Existing Documentation and Issuance of Employer Identification Numbers

In order to avoid withholding under the FATCA provisions, FFIs are generally required to enter into an "FFI Agreement" with the Secretary in which such FFI (an "Participating FFI") agrees to obtain information concerning whether the accounts it maintains are "US accounts" for purposes of the FATCA provision. The Code provides that the term "US account" includes any financial account that is held by certain US persons (excluding corporations the stock of which is regularly traded on an established securities market, any member of such corporation's expanded affiliated group and certain banks) or is held by certain foreign entities with substantial US owners. The Notice clarifies that Participating FFIs will be permitted to rely on Forms W-9 they collect for other US tax purposes, and will generally be required to treat accounts of individuals that are so documented as US accounts under the FATCA provisions. Participating FFIs will also be required to collect Form W-8BEN or Form W-9 from certain of their account holders. The Service intends to issue employer identification numbers to Participating FFIs ("FFI EINs"), which will be used to identify Participating FFIs to withholding agents and other Participating FFIs.

B. Identification of Financial Accounts by Financial Institutions

The Notice provides preliminary guidance on the specific procedures that may be required in order for Participating FFIs to determine which (if any) of the accounts it maintains are US accounts. The Notice provides that future guidance will establish procedures for accounts held by individuals and entities, and that these procedures may vary for accounts in existence on the date the Participating FFI's FFI Agreement becomes effective and those accounts that are opened after such date. Specific guidance is provided regarding the types of indicia of potential US status that would mandate additional due diligence follow-up by the Participating FFI. For accounts containing indicia of potential US status, Participating FFIs will generally be required to obtain documentary evidence establishing US or non-US status of the account holder (e.g., Forms W-9 (if an account holder is a US resident or citizen) or Forms W-8BEN and documentary evidence

establishing non-US status of the individual account holder). Furthermore, the Notice provides that US financial institutions will be required to apply procedures similar to the procedures that FFIs are required to apply for accounts held by entities.

V. Reporting on US Accounts

A. Required Information Reported by Foreign Financial Institutions

The Notice provides preliminary guidance on the manner in which an FFI must annually provide information to the Service with respect to their US accounts pursuant to its FFI Agreement, indicating that the Service is developing a new form that will be filed electronically. Furthermore, the Notice explains that the account number to be reported with respect to an account may be an actual account number, or, if no account number is used by the FFI, a serial number or other number the FFI assigns to the financial account that is unique and will distinguish the specific account. In addition, the account balance or value generally will be required to be reported in US dollars.

B. Election to Be Subject to Same Reporting as US Financial Institutions

Under the FATCA provisions, a FFI may also elect to provide the Service with information as if it was a US person and as if each US holder of a US account was an individual and citizen of the United States. Such an election would require the FFI to file information returns such as Forms 1096 and 1099. If such an election is made, however, the FFI must still report the name, address and taxpayer identification number of each account holder that is a specified US person and each substantial US owner of any account holder that is a US-owned foreign entity, as well as the account numbers. Future guidance will detail the time and manner for making the election and the conditions for meeting the reporting requirements of the election.

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